International Tax Primer

Third Edition

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Preface

The first edition of the *International Tax Primer* began in the 1990s as a project to develop materials for the OECD to use in its outreach activities with emerging economies in Europe after the breakup of the Soviet Union. I recruited Mike McIntyre of Wayne State University to work with me in preparing those materials. Unfortunately, the materials we prepared proved to be unacceptable to the OECD largely because, in our view at least, it did not adhere sufficiently to the OECD positions on several international tax issues. However, the OECD generously permitted us to use those materials as the foundation for what became the *International Tax Primer*.

Much to my surprise and delight, the first two editions of the Primer were well received by students of international tax from all over the world. I hope that a new generation of students will find this third edition to be helpful in the increasingly challenging task of understanding international tax.

The third edition does not have the benefit of Mike McIntyre's insight and wisdom. Mike passed away in 2013 after a long illness. We discussed the need for a third edition on several occasions, so I know that Mike would have approved of a third edition in principle; but I also know that his involvement would have made it a better book.

The third edition of the International Tax Primer has been expanded substantially. A lot has happened in the international tax world since the second edition was published in 2004. The chapters on transfer pricing, anti-avoidance rules, and tax treaties have been substantially revised to reflect the changes of the last decade. Similarly, the chapter dealing with recent developments has been changed significantly to deal with the OECD's Base Erosion and Profit Shifting project, arbitration of tax disputes, and the proposed article in the United Nations Model Treaty dealing with fees for technical services, none of which were dealt with in the second edition. In addition, new chapters have been added dealing with basic aspects of the taxation of residents on their foreign source income and nonresidents on their domestic source income.

Large ongoing projects, such as BEPS, pose a special challenge for authors. Obviously, BEPS is so important that it cannot simply be ignored. However, when we do not know what the final recommendations will be and whether countries will act on them, it is difficult to decide how much detail to provide on the draft proposals. I have

opted to provide a somewhat detailed discussion of the BEPS project in general in Chapter 9 dealing with Emerging Issues, and at least a brief mention of each BEPS action item at places in the book where a particular topic is dealt with. Needless to say, I anticipate that a fourth edition of the Primer will be necessary in a few years once the full impact of the BEPS project is clearer.

Readers will quickly notice that the Primer does not contain any footnotes or a selected bibliography. Given the basic nature and purpose of the Primer, I concluded that footnotes were unnecessary and would make the text less readable; however, any references that I considered to be necessary are provided in the text. I also concluded that a selected bibliography was unnecessary, largely because there is an extensive literature dealing with international tax and, with the Internet, it is relatively easy to find relevant sources.

I wish to thank my assistant, Carol Hargreaves, who edited and proofread the manuscript with her customary skill more than once.

The manuscript is up to date as of September, 2015.

Brian J. Arnold
Ailsa Craig, Ontario, Canada
September 2015

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.

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.

CHAPTER 2
Jurisdiction to Tax

2.1 INTRODUCTION

Income may be taxable under the tax laws of a country because of a nexus between that country and the income or the activities that generated the income. According to international usage, a jurisdictional claim based on such a nexus is called "**source jurisdiction**". All countries that impose an income tax exercise source jurisdiction: that is, they tax income arising or having its source in their country.

A country may also impose tax on income because of a nexus between the country and the person earning the income. Such a jurisdictional claim over a person's income is called "**residence jurisdiction**". Persons subject to the residence jurisdiction of a country are generally taxable on their worldwide income, without reference to the source of the income - that is, the person is typically taxable on both domestic source income and foreign source income.

It is frequently said that most countries tax residents on their worldwide income and nonresidents on the domestic source income. Although this statement contains a grain of truth, it is a gross oversimplification of the scope of the tax systems of most countries. Countries that are said to tax their residents on their worldwide income never tax all of their residents on all of their worldwide income. Instead, these countries usually exempt their residents, especially resident corporations, on their income from active business carried on in foreign countries and income earned by foreign corporations in which their residents own shares. Similarly, countries that are said to tax on a territorial basis - that is, they tax only income derived from a source in their countries - often impose tax on certain items of foreign source income, such as fees paid by residents to nonresidents for technical services performed outside the country.

With few exceptions, countries that exercise residence jurisdiction do so only with respect to the income of individuals and legal entities that they consider to be residents: thus the term "residence jurisdiction". A few countries - the United States

(US) is the primary example - exercise jurisdiction to tax their citizens as well as their residents. They assert the right to impose income tax not only on the worldwide income of their residents, but also on the worldwide income of their citizens wherever they might be resident.

When a resident of a country earns income derived outside that country (foreign source income), the claim of that country to tax the income based on its residence jurisdiction may overlap with the claim of the country where the income is earned to tax based on its source jurisdiction. The claims of countries for tax revenue based on residence jurisdiction may also overlap with the claims of other countries based on citizenship or, in the case of so-called "**dual-resident taxpayers**", on residence. In addition, countries with conflicting source-of-income rules may both claim to tax the same income. Unless resolved satisfactorily, the competing claims for tax revenue based on residence and source would discourage international commerce and investment. In addition, the tax burdens imposed on individuals earning income from cross-border transactions would be unfair under traditional concepts of tax equity. The measures that countries have adopted in their domestic legislation and tax treaties to mitigate international double taxation are addressed in Chapter 4.

Although persons engaging in transnational activities face risks of double taxation, they also have possibilities for international tax avoidance (sometimes referred to as double non-taxation). These opportunities result from certain gaps in the residence and source jurisdictions of most countries. The under-taxation of income from cross-border transactions is both inefficient and unfair. Under-taxation is inefficient because it distorts economic behavior; it induces taxpayers to engage in the under-taxed activities instead of taxable activities that may produce higher before-tax rates of return. It is unfair because individual taxpayers earning equal amounts of income do not pay the same amounts of tax.

Tax haven countries increase the risks of under-taxation of transnational income. Although tax havens may obtain some revenue from foreign taxpayers, the amount is small in comparison with the amount of tax revenue that other taxing jurisdictions lose on account of their conduct. The tax laws of many countries are replete with complex provisions designed to protect the legitimate tax claims of countries against the beggar-thy-neighbor policies and preferential regimes of tax haven countries. The most important anti-avoidance rules are addressed in Chapter 7.

Unilateral action by countries to block tax haven abuses has often been ineffective, due in significant part to the inability of the source and residence countries to obtain information about transactions routed through tax havens. Until recently, tax havens had strict bank secrecy rules and similar non-disclosure rules that facilitated tax avoidance and evasion by multinational enterprises and wealthy individuals resident in other countries. In the last decade or so, however, through a sustained project initiated and led by the OECD, bank secrecy has been eliminated and the exchange of information between countries to prevent tax avoidance and evasion has been improved significantly. The recent efforts to facilitate exchange of information for tax purposes are discussed in Chapter 8, section 8.8.4.

2.2 DEFINING RESIDENCE

For the purposes of taxing residents (and nonresidents), a country must provide rules that classify individuals and legal entities either as residents or nonresidents. The rules for determining the residence of individuals and legal entities are discussed below in sections 2.2.1 and 2.2.2, respectively. Certain tax treaty issues involving the determination of residence are addressed in section 2.2.3, below. The rules for determining residence (and, as a consequence, nonresidence) are clearly necessary for taxing residents on their domestic and foreign source income, but they are also necessary for taxing nonresidents on their domestic source income. The source of some types of domestic source income, such as dividends and interest, are usually based on the residence of the payer.

2.2.1 Residence of Individuals

An ideal test of residence is one that individuals and tax officials can apply to obtain a clear, certain, and fair result. Certainty is highly desirable because the tax consequences for residents and nonresidents are different, and individuals need to know whether they are resident or nonresident in order to comply with a country's tax law. Nevertheless, a simple and certain test for residence may be arbitrary and unfair, and may result in many individuals who engage in cross-border activities ending up as residents of more than one country. Therefore, the most that can be expected is a test that is simple, certain, and fair for the overwhelming majority of taxpayers but that is supplemented by more refined rules to deal with special circumstances.

In many countries, the residence of individuals is determined under a broad facts-and-circumstances test. The most significant manifestation of an individual's allegiance to a country is probably the maintenance in the country of a dwelling that is available for the use of the individual and his or her family. The following factors are also usually relevant:

- the location of the individual's income-producing activities;
- the location of the individual's family;
- the social ties of the individual to the country (e.g., bank accounts, club memberships, driver's license, etc.);
- the individual's visa and immigration status; and
- the individual's actual physical presence in the country.

Under this test, the tax authorities of a country decide, based on largely objective facts, whether an individual's economic and social connections with the country justify taxing the individual as a resident.

Unless buttressed by some simple presumptions, a facts-and-circumstances test is unsatisfactory because it is often excessively difficult to apply. A facts-and-circumstances test that uses certain objective tests to establish presumptions may provide a good balance between certainty and fairness. It may be appropriate for such a test to apply more rigorously in situations in which a taxpayer is attempting to give

up residence in a country than in situations in which a taxpayer is acquiring residence in the country. The following presumptions might be used, separately or in combination, to establish a prima facie case for residence:

- Individuals present in a country for 183 days or more in a taxable year are residents for that year, unless perhaps they establish that they do not have a dwelling in the country and are not citizens of the country.
- Individuals having a dwelling in the country are residents unless they also have a dwelling in another country.
- Citizens of a country are residents unless they have established a dwelling abroad and are regularly outside the country for more than 183 days per year.
- Individuals who are domiciled in a country may be considered to be residents of that country.
- Individuals who are temporarily absent from a country but intend to return and resume residence in the country may be presumed to remain residents of the country despite their temporary absence, subject to the rebuttal of that presumption.
- Individuals who have established residence in a country cannot relinquish residence status until they have clearly established residence status in another country.
- Individuals who have either resident or nonresident status for visa or immigration purposes might be presumed to have the same status for income tax purposes, although that presumption might be rebuttable.

Special rules may be necessary for certain individuals. For example, it may be appropriate to deem diplomats, military personnel, and other government employees to be residents of the country that employs them despite the fact that these individuals might not be residents on the basis of a facts-and-circumstances test because they spend most of their time outside the country.

Some countries use an arbitrary test, often tied to the number of days of presence in the country, for determining residence. Such a test may be used as a supplement to the facts-and-circumstances test discussed above. A common, but defective, rule or presumption is that an individual who is present in a country for at least 183 days during the year is a resident for that year. The 183-day test is probably enforceable in countries that exercise tight control over their borders; however, it is extremely difficult for the tax authorities of a country to enforce when many individuals are frequently entering and leaving the country without border checks, as occurs in the countries of the European Union. In most countries, the test probably cannot operate effectively unless the burden of proof is put on the individual to prove that he or she is not present for the 183-day period. Many individuals with substantial economic ties to a country can easily avoid becoming resident under the 183-day test by leaving the country before the 183-day threshold is passed. As a result, a country using that test is likely to catch mainly unsophisticated or ill-advised individuals, some of whom may not in fact have substantial ties to that country.

Domicile is a legal concept under the law of some countries by which an individual's permanent connection with a country is established. In general, domicile involves a more permanent connection with a country than residence. A person's domicile may be the country in which the person is born or in which the person's mother or father is domiciled.

2.2.2 Residence of Legal Entities

The residence of a corporation is generally determined either by reference to its place of incorporation or its place of management, or both. The **place-of-incorporation test** provides simplicity and certainty to the tax authorities and the corporation. It also allows a corporation to freely choose its initial place of residence. Countries that market themselves as tax havens typically offer convenient and inexpensive arrangements for incorporating under their laws.

In general, a corporation cannot freely change its place of incorporation without triggering a tax on gains that may have accrued in respect of its property, including intangible property that may have a high market value. Consequently, the place-of-incorporation test places some limits on the ability of corporations to shift their country of residence for tax avoidance purposes. Many countries use the place-of-incorporation test, although it is often combined with another test.

The **place-of-management test** is less certain in its application than a place-of-incorporation test, at least in theory. For many corporations engaged in international operations, management activities may be conducted in several countries during any particular taxable year. In practice, most countries using that test employ practical tests, such as the location of the company's head office or the place where the board of directors meets, to determine the place of management. The place-of-management test is used by the United Kingdom (UK) and many of its former colonies. Some countries, such as Australia, Canada, and the UK, use both the place-of-incorporation test and the place-of-management test.

A place-of-management test is easily exploited for tax avoidance reasons where a change in the place of management can be accomplished without triggering any tax. Assume, for example, that ACo is a corporation resident in Country A, which uses a place-of-management test. ACo has developed valuable intangible property that it intends to license to taxpayers located in Country B. To avoid tax in Country A on the expected royalties, ACo shifts its place of management to Country H, a low-tax country. The large accrued gain on ACo's intangible property is not taxable in Country A because no transfer of that property occurred. (However, as discussed in Chapter 3, section 3.4.1, several countries have adopted **exit or departure taxes** to prevent taxpayers from avoiding tax by changing their residence.) ACo then licenses the technology to users in Country B. The royalties received by ACo escape taxation in Country A because ACo is no longer resident in Country A.

If Country A in the above example used the place-of-incorporation test, ACo could not transfer its residence to Country H without undergoing a corporate reorganization that would probably result in the transfer of its assets to a corporation

organized in Country H. Such a transfer would trigger a realization of the accrued gain on the intangible property, thereby limiting or even eliminating ACo's opportunity for tax avoidance.

Countries that use a place-of-incorporation test exclusively (such as the US) have encountered avoidance schemes, called corporate inversions, whereby resident multinationals reorganize to avoid aspects of the residence country's tax system. Although inversions take many forms and are invariably quite complex, the following simplified example illustrates the general idea.

Assume that USCo, a widely held US-based multinational, wants to avoid the effects of the US CFC rules (discussed in Chapter 7, section 7.3). To do so, it establishes a subsidiary (Forco) in a country without CFC rules and then arranges for its shareholders to exchange their shares of USCo for shares of Forco and for the shares of all USCo's foreign subsidiaries to be transferred to Forco. The end result is that Forco is not a CFC in respect of any of its US shareholders and the CFC rules are no longer applicable to USCo because its foreign subsidiaries have become subsidiaries of Forco.

Many commentators argue that the proper purpose of the corporate tax is to impose tax burdens on a corporation's individual shareholders. According to this view, the corporate tax is paid in advance on behalf of the individual shareholders of the corporation to prevent them from deferring tax by investing in corporations. Therefore, the test of residence of a corporation might be determined, at least in theory, by reference to the residence of its shareholders. However, the application of a residence-of-the-shareholders test would present serious problems when residents of more than one country hold large blocks of stock in the company or when the stock of the company is publicly traded and the identity of the shareholders is difficult to determine. Taking this view to its logical conclusion, in effect, corporations would have to be taxed like partnerships, with each country taxing the share of the corporate income attributable to its resident shareholders.

For legal entities other than corporations, residence is generally determined either under a place-of-organization test or a place-of-management test. Determining the residence of a partnership is sometimes difficult because of the informality with which a partnership can be established: for example, in some countries a partnership may be created by virtue of the course of conduct of the relevant parties without the necessity for any formal legal documentation. In many countries, partnerships are treated as transparent or flow-through entities for tax purposes: in other words, the partners are taxed on their share of the income of a partnership, but the partnership itself is not taxed. For these countries, the residence of a partnership is usually irrelevant because the partnership is not a taxable entity.

Difficult problems also can arise under the laws of some countries in determining the residence of trusts. These problems are especially difficult when the country of organization, the country where the trustee or trustees are resident, the country where the grantor or settlor is located, and the countries where the beneficiaries are located are all different.

2.2.3 Treaty Issues Relating to Residence

Under Article 4(1) of the OECD Model Treaty, a "resident" of a country for purposes of the treaty is a person who is liable to tax in that country "by reason of his domicile, residence, place of management or any other criterion of a similar nature". Article 4(1) of the United Nations (UN) Model Treaty adds "place of incorporation" to the list of connecting factors. To avoid situations in which an individual is considered to be resident in both countries, Article 4(2) of both Models provides a series of **tie-breaker rules** to make the individual resident in only one country for purposes of the treaty. The first tie-breaker is the place where an individual has a permanent home; the second tie-breaker is the country in which the center of the individual's vital interests is located; the third is the place of the individual's habitual dwelling; and the fourth is the country of citizenship. If these tie-breaker rules are ineffective in making an individual a resident of only one country for treaty purposes, the "**competent authorities**" of the two Contracting States are mandated to determine residence by **mutual agreement**. Most modern tax treaties follow the tie-breaker rules in the OECD and UN Model Treaties closely.

For legal entities resident in both Contracting States, Article 4(3) of the OECD and UN Model Treaties make the entity a resident of the country where its place of effective management is located. According to the **Commentary** on Article 4, the place of effective management of an entity is the place where key management and commercial decisions are in substance made – the place where decision-making at the highest level on the most important issues of management takes place. Moreover, according to the Commentary, an entity can have only one place of effective management, although it can have multiple places of management. In my view, the Commentary dealing with the place of effective management is not convincing. Given the flexibility in the structure of the management of entities, it seems likely that key decisions can be made in multiple locations.

The place of effective management tie-breaker rule is not likely to be acceptable to countries that use a place-of-incorporation test as the sole test of residence for corporations. Many treaties attempt to resolve conflicts over the residence of entities by leaving the issue to the competent authorities to resolve. Some treaties use place of incorporation as the tie-breaker if the company involved is incorporated in one of the treaty countries. Other treaties provide that a dual-resident company is not considered to be a resident of either country for most treaty purposes; therefore, such a company is not entitled to any of the benefits of the treaty. This provision is intended to prevent the use of dual-resident companies for tax avoidance purposes; for example, a dual-resident company with losses would be entitled to relief for such losses in both countries in which it is resident.

The US insists on the inclusion in its tax treaties of what is commonly referred to as a "saving clause". The typical saving clause provides, with some exceptions, that the US reserves the right to tax its residents and its citizens as if the treaty had not come into effect. For example, a US citizen resident in a treaty country is not entitled to the reduced rate of withholding provided in the treaty on dividends received from the US. The OECD's BEPS Action 6: *Preventing the Granting of Treaty Benefits in Inappropriate*

Circumstances proposes to add a similar saving clause to the OECD Model Treaty (see Chapter 8, section 8.8.2.3).

2.3 SOURCE JURISDICTION

2.3.1 Introduction

By international custom, a country has the primary right to tax income that arises in, has its source in, or is derived from that country. As discussed in Chapter 3, under international custom the country of residence is generally expected to provide relief from double taxation if its residence jurisdiction overlaps the source jurisdiction of another country. In other words, the country in which a taxpayer is resident has only a secondary right to tax the taxpayer's income that is derived from or sourced in another country. Most tax treaties provide that the country in which income is sourced has the first right to tax that income and that the country of residence has an obligation to eliminate double taxation of that income. Although tax treaties give a country the first right to tax income sourced in the country, they usually provide that the source country must limit its rate of tax on certain categories of investment income and preclude the source country from taxing certain categories of income, even if the income arises in the source country.

Despite the priority given to source jurisdiction, the concept of source is rather poorly developed in domestic tax legislation and tax treaties. Unlike the term "residence", the term "source" is not used or defined in domestic law or in tax treaties. Thus, source rules are usually implicit in other rules. For example, withholding tax imposed on amounts paid by residents to nonresidents has an implicit source rule that such amounts are sourced in a country if they are paid by a resident of the country.

Most countries have only sketchy rules for determining the source of income, especially income derived from business activities. For example, in the UK and countries that were former UK colonies, income from business activities is considered to have its source where the real business is carried on. Such a rule is too vague to provide any guidance to taxpayers or tax officials.

The OECD and UN Model Treaties provide a mixture of implicit source rules and rules that function effectively like source rules. For example, under Article 11(4), interest income is taxable by the country in which the payer is resident and under Article 6, income derived from immovable property, including income arising from the operation of a mine or well, is taxable by the country where the immovable property is located. However, the OECD and UN Model Treaties do not contain any explicit source rules for business profits. Under Article 7, business profits derived by a resident of one **contracting state** are taxable by the other contracting state only if the resident carries on business through a **permanent establishment** (**"PE"**) located in that other state (Article 7) and the profits are attributable to the PE. This rule is the functional equivalent of a source rule.

In general, a PE is a fixed place of business, such as an office, branch, factory, or mine. The OECD and UN Model Treaties (Article 5) treat a dependent agent as

constituting a PE of its principal in some circumstances. Activities relating to the purchase of goods for export generally do not cause a taxpayer to have a PE. For additional discussion of PE rules, see Chapter 8, section 8.7.3.2.

Some provisions of the OECD and UN Model Treaties, such as Article 21 (Other Income), contain general wording that refers to income arising in a contracting state, without any further elaboration. In these circumstances, it seems inevitable that the source of income for that particular purpose must be determined under the domestic law of the country applying the treaty.

Good source rules should have the following characteristics:

- They should be broadly acceptable by many countries in order to ensure that double taxation is eliminated and double non-taxation is not facilitated.
- They should allocate income and tax on a reasonable basis that is broadly acceptable by most countries.
- They should be relatively clear and simple for taxpayers and tax officials to apply.
- They should be applicable on a reciprocal basis (i.e., a country should not unilaterally adopt a source rule that it would object to another country adopting).
- They should allocate income to a country where the income has a substantial economic connection (in the language of the OECD's BEPS project, income should be taxable in the country where value is added or created).
- They should not be subject to manipulation by taxpayers.
- They should not allocate income to countries that do not impose tax.

The source rules generally applicable to employment and personal services income, business income, and investment income are discussed below. The modifications of those source rules contained in the OECD and UN Model Treaties are also discussed.

2.3.2 Employment and Personal Services Income

The general rule in many countries is that income derived from personal services performed by employees, independent contractors, or professionals has its source in the country where the services are performed. Difficult allocation issues may arise when a taxpayer is paid for services performed in more than one country. Allocation among the countries where an individual performs services is typically based, at least in part, on the amount of time spent by the individual performing the services in each country. Some countries, including several South American and Latin American countries, consider income from services to be derived in their countries if the services are consumed or used (by customers or clients) in their countries even if the services are performed outside their countries.

Under Article 14 of the UN Model Treaty, income from services derived by professionals and other independent contractors is taxable by the country in which the

services are performed only if the service provider has a *fixed base* (which is equivalent to a PE) regularly available in the source country or spends at least 183 days in the source country. The OECD Model Treaty provided a similar exemption until the elimination of Article 14 in 2000. In tax treaties following the OECD Model Treaty, income from professional and other independent services is taxable as business profits under Article 7 and is exempt from tax by a country unless the service provider has a PE (rather than a fixed base) in that country. Under the UN Model Treaty, a taxpayer resident in one contracting state is deemed to have a PE in the other state if the taxpayer furnishes services in the other state through employees or other personnel with respect to the same or a connected project for a period of more than 183 days in any twelve-month period beginning or ending in the year. The Commentary on Article 5 of the OECD Model Treaty provides a similar deemed services PE rule as an alternative provision that countries may adopt.

One effect of eliminating Article 14 from the OECD Model Treaty has been to clarify that the various exceptions to PE status for preparatory and auxiliary activities in Article 5(4) and the agency PE rules in Articles 5(5) and (6) are equally applicable to income from professional and independent services. Both of these issues remain unresolved under the UN Model Treaty.

Article 15 of both the OECD Model Treaty and the UN Model Treaty provides that income from employment is taxable exclusively by the country in which an employee is resident unless the employment is exercised in the source country and the following conditions are met:

(1) the employee must be present in the source country for no more than 183 days;
(2) the employee is not paid by or on behalf of an employer resident in the source country; and
(3) the employee's remuneration is not deductible in computing the profits attributable to a PE in the source country of a nonresident employer.

In other words, an employee resident in one contracting state will be taxable by the other state on any income from employment duties performed in the other state for an employer resident in that state or for a nonresident employer with a PE in that state if the employee's remuneration is borne by the PE. Otherwise, income of an employee resident in one contracting state from employment exercised in the other contracting state is taxable by that other state only if the employee is present in the other state for 183 days or more in any twelve-month period beginning or ending in the relevant year. (See Chapter 8, section 8.7.3.3.)

2.3.3 Business Income

The taxation of business income by source countries varies considerably. However, two general patterns can be noted. The most common pattern, consistent with Article 7 of the OECD and UN Model Treaties, is that business income is generally taxable by

a country only if the taxpayer carries on business through a PE in the country and the income is attributable to that PE. In these systems, the PE rules serve not only as a threshold for taxation but also as the means for identifying the income subject to tax, namely, income "attributable" to the PE. Most European countries follow this general pattern; however, the definition of a PE under domestic law is often broader than the definition in tax treaties.

In many Latin American and South American countries, the PE concept is used to differentiate between the taxation of income from services derived by nonresidents on a net or a gross basis. Nonresidents who earn income from services through a PE situated in a country are taxable by that country on a net basis (i.e., the nonresidents are allowed to deduct expenses incurred in earning the income). Nonresidents who earn income from services performed in a country or consumed in the country but who do not have a PE in the country are taxable on a gross basis (without the allowance of any deductions) through a withholding tax.

According to Article 7 of the OECD and UN Model Treaties, the amount of income attributable to a PE is determined by assuming that the PE is a separate legal entity and that it deals at arm's length with other parts of the enterprise, including the head office, of which it is a part. Transactions between a PE and the head office are subject to the arm's-length transfer pricing rules. Transfer pricing rules are discussed in Chapter 6. In practice, most countries determine the income of a PE by relying heavily on the books of account of the PE, with adjustments made to those books only in cases of perceived abuse. The effect is to give substantial discretion to taxpayers to determine the business profits attributable to a PE. The rules for the attribution of profits to PEs are discussed in Chapter 8, section 8.8.5.

The other general pattern for taxing business profits is that the concept of a PE (or some functional equivalent) is used as a threshold requirement for the taxation of nonresidents but explicit source rules are used to determine the extent of the income subject to tax. The US is the most prominent example of this approach. Under US law, most categories of gross income are assigned a source. Deductions are then associated with items of gross income, generally in accordance with accounting conventions. Some items of business income are assigned exclusively either to the US or to foreign countries. For example, income derived from the purchase and sale of personal property is considered to have its source in the country of sale. Other categories of income are apportioned between foreign countries and the US, often by formula. For example, income from the manufacture and sale of personal property is apportioned between the country of manufacture and the country of sale, typically by a two-factor formula (sales and property). Telecommunications income generally is apportioned equally between the country of origin of the telecommunication signals and the country of reception.

A key feature of US source rules is the treatment of deductions. Many deductions are linked with gross income under accounting rules comparable to inventory accounting rules, under which deductions such as depreciation and other fixed costs are allocated for purposes of determining the cost of goods sold. However, special detailed rules apply to interest payments, research and development expenses, and certain other expenses that are difficult to link with specific items of gross income.

Most countries lack sophisticated source rules with respect to income and deductions. Accordingly, income and deductions are allocated between domestic and foreign income in accordance with general rules that give considerable discretion to taxpayers.

2.3.4 Investment Income

With some exceptions, most countries tax investment income derived by nonresidents, such as dividends, interest, and royalties, through withholding taxes imposed on the gross amount of the payment at a flat rate. Capital gains are not usually subject to withholding tax, although special enforcement measures are used by some countries, as discussed in Chapter 5, section 5.8.5. The source of investment income is usually determined by implicit source rules or their functional equivalents. With some technical exceptions, the following rules have been adopted by most countries and are endorsed in the OECD and UN Model Treaties.

- Interest, dividends, and royalties are considered to arise or be sourced in the country of residence of the payer. (See Articles 11(4) and 10(4) of the OECD and UN Model Treaties and Article 12(4) of the UN Model Treaty.) It is notable that the source rule for investment income relies on the residence of the payer of the interest, dividends, or royalties. Therefore, even countries that tax exclusively on the basis of the source of income (territorial taxation) require rules to determine the residence of persons. Special rules may apply to interest that is deductible in computing the profits attributable to a PE.
- Royalties paid with respect to intangible property are considered to arise in and are taxable by the country where the property is used and that provides legal protection for the intangible property. Some types of royalty income, such as royalties paid for the showing of motion pictures and royalties on computer software, may be classified as business income under the laws of some countries. No source rule for royalties is necessary in the OECD Model Treaty because exclusive jurisdiction to tax royalties is given to the residence country. However, under Article 12 of the UN Model Treaty the source country is entitled to tax royalties, with the setting of a maximum withholding rate left to negotiations between the treaty partners. Under Article 12(4), royalties are considered to arise in the country where the payer is resident or, in the case of royalties deducted in computing the income of a PE, in the country where the PE is located.
- Rental income derived from the operation of a business is typically taxable under the rules applicable to business income discussed above. Rental income from immovable property is taxable by the country in which the property is located; therefore, implicitly the source of the royalties is that country. Rental income from the use of movable property is generally taxable by the country where the property is used; therefore, implicitly the source of the income is the country in which the payer is resident. Rental income derived from movable

property is taxable as business profits under Article 7 of the OECD Model Treaty and as royalties under Article 12 of the UN Model Treaty.
- The source of gains from the disposal of property varies considerably and depends on the nature of the property. Gains from the disposal of immovable property are almost invariably taxable by the country in which the property is located. This is the rule in Article 13(1) of the OECD and UN Model Treaties. Gains from the disposal of assets used in carrying on a business in a country are often taxable by the country in which the business is carried on. Under Article 13(2) of the OECD and UN Model Treaties, gains from the disposal of property used in carrying on a business through a PE in a country are taxable by that country. The structure of the OECD and UN Model Treaties allows the same country to tax both income and capital gains from the disposal of immovable property and assets forming part of a PE. Thus, the characterization of a gain as income or capital gain is determined under domestic law and is not relevant for purposes of the treaty.

Gains from the disposal of shares of companies or interests in a partnership or trust are generally subject to tax exclusively by the country in which the taxpayer is resident. However, if a nonresident taxpayer owns a substantial interest in a resident entity, some countries impose tax on the gains. Article 13(4) of the UN Model Treaty allows a Contracting State to tax such gains, but the OECD Model Treaty does not. Similarly, some countries tax gains from the disposal of shares in a corporation or interests in a partnership or trust if the value of the shares or interests is derived principally from immovable property located in those countries and owned by the entity. Both the OECD and UN Model Treaties allow the Contracting States to tax such gains. In effect, this provision is an anti-avoidance rule designed to prevent taxpayers from avoiding a country's tax on gains in respect of immovable property located in the country by transferring the property to a corporation or other legal entity established in the country, and then disposing of the shares of the corporation or interests in the entity.

As noted above, most countries entering into tax treaties agree to some limitations on the withholding tax rates applicable to interest, dividends, and royalties under their domestic laws. The intent of these limitations is to ensure that the source country does not impose excessive taxes on investment income and tax revenue is shared between the source country and the residence country. For a discussion of withholding taxes, see Chapter 5, section 5.9.2 and Chapter 8, section 8.7.3.5.

Some tax treaties eliminate source country taxation entirely for some types of investment income by mandating a zero rate of withholding; almost all of these treaties are between developed countries. The zero rate is premised on two assumptions: that the flow of investment funds between the treaty countries in the zero-rate categories is approximately equal, and that the tax jurisdiction relinquished by the source country will be exercised by the residence country. As discussed in Chapter 8, section 8.2.1, these assumptions do not reflect reality in many circumstances.

Some commentators favor residence taxation of investment income over source taxation on the ground that a withholding tax at source may operate in some

circumstances as an excise tax on the payer, whereas a residence tax generally operates as an income tax on the recipient of the income. As an example of this excise-tax effect of withholding taxes, consider a foreign bank that requires a borrower to make interest payments net of any withholding tax imposed by the source country. In such circumstances, the borrower is likely to view the withholding tax as an additional cost of borrowing.

In theory, zero rates of withholding simplify administration and promote business efficiency by allowing intercompany transfers to be made without tax consequences. In practice, zero rates may promote tax avoidance schemes and, in the absence of complex anti-avoidance rules, may provide unintended benefits through treaty shopping. Treaty shopping occurs, for example, when treaty benefits are obtained by corporations that are nominally resident in a treaty country but are owned beneficially by nonresidents. For a discussion of treaty shopping, see Chapter 8, section 8.8.2.2.

CHAPTER 3

Taxation of Residents

3.1 INTRODUCTION

As discussed in Chapter 2, many countries tax persons - individuals and legal entities - who are residents on their worldwide income and nonresident persons only on their domestic source income. Thus, the essential difference between the taxation of residents and nonresidents is that nonresidents are taxed only on income derived from a country (domestic source income) while residents of a country are taxed on both their domestic source income and their income derived from outside the country (foreign source income). Although a few countries tax only domestic source income (so-called territorial taxation), most countries tax resident persons on at least some of their foreign source income. Therefore, the typical pattern of taxation internationally can be described as the taxation of residents on both their domestic source income and at least some items of their foreign source income. The taxation of nonresidents is dealt with in Chapter 5.

The distinction between resident persons and nonresident persons is a fundamental one and has important consequences. As discussed in Chapter 2, the determination of the residence of a person is usually based on the person's connections to a country, although the specific rules vary considerably from country to country. The closer and more extensive a person's connections are with a country, the more likely it is that the person will be considered to be a resident of that country for purposes of its tax system.

This chapter examines the major issues involved in taxing residents on their worldwide income other than the determination of residence itself, which is dealt with in Chapter 2. Initially, it considers the tax policy reasons for taxing residents on their worldwide income and then several more practical issues, such as the computation of foreign source income, departure or exit taxes, **trailing taxes**, the treatment of temporary residents, and foreign exchange gains and losses.

3.2 TAXATION OF RESIDENTS ON THEIR WORLDWIDE INCOME

3.2.1 Tax Policy Considerations

It may seem initially that countries that impose tax on the worldwide income of their residents are exceeding their sovereign authority to tax because they are taxing income that arises outside their territories **(extraterritoriality)**. However, there are no international law constraints on a country's legal authority to tax persons who have close connections to the country. There are practical constraints on a country's ability to tax, since it makes little sense for a country to impose taxes that cannot be effectively collected. However, tax on the worldwide income of residents can be effectively collected because, by definition, the residents of a country are persons with significant ties to the country.

The tax policy justifications for taxing resident individuals on their worldwide income are equity and neutrality. If two residents have equal amounts of income, they should be subject to the same tax burden, even if one resident's income is derived totally from domestic sources while the other's income is derived exclusively from outside the country. This equity justification is based on the assumption that all residents of a country derive significant personal benefits from the country in the form of public goods and services that justify taxing them irrespective of the source of their income. The neutrality justification is that a country should not create a tax incentive for its residents to work or invest outside the country. If the foreign source income of residents is not subject to residence country tax, residents have an incentive to earn low-taxed foreign source income in preference to domestic source income, and this incentive is detrimental to the domestic economy.

With respect to corporations and other legal entities, considerations of equity are of little significance because such entities are not the ultimate beneficial owners of their income. Accordingly, the justification for taxing legal entities on their worldwide income must rest primarily on the neutrality argument. This form of neutrality is referred to as capital-export neutrality - a taxpayer should invest where the pre-tax return is maximized. To achieve this type of neutrality, a country must tax its resident entities on income from both foreign and domestic investments. If income from foreign countries is not taxed, legal entities resident in a country will prefer to invest in foreign countries with lower tax rates, and especially in tax havens with no or low taxes.

There is, however, another side to the neutrality argument with respect to business income - capital-import neutrality or international competitiveness - which suggests that entities resident in one country must compete in various countries with entities resident in those countries and with third countries. If the entities resident in Country A are subject to tax by Country A on their worldwide income, they will not be able to compete as effectively in Country B as entities resident in Country B or resident in third countries that are subject to tax only in Country B. The arguments concerning international competitiveness, although complex and controversial to academics, have proved irresistible to governments. As a result, it is fair to say that the international norm is that active business income derived by legal entities is generally taxed on a territorial basis; in other words, the foreign source business income derived by a

resident corporation is not usually subject to residence country tax. This point is explained in more detail below.

It might be thought that one of the reasons for a country to tax its residents on their foreign source income is the additional tax revenue that will be generated. However, as explained in Chapter 2, to the extent that such income is subject to tax in the country in which it is derived (the source country), that country has the first right to tax the income. The residence country is generally considered to be under an obligation (although not a legal obligation unless there is a treaty in effect between the two countries) to eliminate double taxation, either by exempting the foreign source income from residence country tax or by providing a credit against residence country tax for the source country tax on the foreign source income. Thus, additional tax revenue will be generated only if the residence country eliminates double tax through a **foreign tax credit** and only to the extent that the source country tax is less than the residence country tax. The **elimination of double tax** is explored in Chapter 4.

3.2.2 The Tax Consequences of Residence

In a worldwide tax system, an individual taxpayer's income includes both income from inside the country in which the taxpayer is resident and income from outside that country. The individual is usually taxable on that worldwide income at progressive rates, although the extent of the progression in the rates may be limited; for example, an amount may be taxable only if the taxpayer's income exceeds a threshold amount. In some countries, although foreign source income is not taxable, it is taken into account in determining the rate of tax on the taxpayer's other income (**exemption with progression**). In some countries, certain types of foreign source income (typically business income) may be exempt while other types are subject to residence country tax. As a result, as noted above, just because a country is described as taxing on a worldwide basis does not mean that it taxes all foreign source income derived by residents.

Example

Ms X is a resident of Country X. She has income from employment in Country X of 100,000. She also receives dividends of 10,000 from corporations resident in Country Y and interest of 3,000 from a bank account in Country Z. The dividends are subject to withholding tax in Country Y of 15 percent, or 1,500, and the interest is subject to withholding tax in Country Z of 10 percent, or 300. Ms X's income and tax payable to Country X might look as follows:

Income from Country X	100,000
Foreign source income	
Dividends from Country Y	10,000
Interest from Country Z	3,000
Worldwide income	113,000

Less: personal allowance	10,000
Taxable income	103,000
Tax payable (40%)	41,200
Less: single parent credit	1,200
foreign tax credit	1,800
Net tax payable	38,200

3.2.3 Double Taxation

If one country taxes its residents on their worldwide income and another country taxes part of that income because it is derived from sources in that country, the income is subject to double tax. Worldwide taxation of residents inevitably results in double tax because most countries insist on taxing income that is derived or has its source in their countries. The well-established international norm is that the source country - the country in which the income has its source - has the first right to tax the income and the residence country has a secondary right to tax the income; however, if the residence country does so, it must provide relief for the source country's tax in order to eliminate double taxation. The methods that residence countries use to eliminate the double taxation of foreign source income earned by their residents are discussed in Chapter 4.

3.2.4 Computation of the Foreign Source Income of Residents

3.2.4.1 In General

Since residents are taxable on their worldwide income, rules are necessary to compute both their domestic source income and their foreign source income. Typically, the same rules apply for the purpose of computing both types of income. The same amounts are included in income; the same deductions are allowed; and the same timing rules apply. However, tax incentives may be restricted to domestic source income. For example, a country may provide accelerated depreciation for investment in machinery and equipment used in certain domestic industries or areas of the country or it may provide enhanced write-offs for domestic research and development.

Source rules are irrelevant for purposes of determining the worldwide income of residents since all income, domestic and foreign, is taxable. However, source rules are required if any items of foreign source income are exempt from tax. In addition, source rules are necessary for purposes of determining the limitation on the foreign tax credit. As discussed in detail in Chapter 4, a country that taxes the foreign source income of its residents is obligated by its treaties (and also by international practice and fairness) to allow a credit against its domestic tax for the foreign tax paid on the foreign source income. However, this credit for foreign taxes never exceeds the amount of domestic tax on the foreign source income.

Expenses incurred to earn foreign source income are clearly deductible if the foreign source income is subject to tax. Sometimes there may be a serious mismatch between the timing of the recognition of the income and the timing of the deduction of expenses. For example, the taxpayer may borrow funds to finance the earning of foreign source income. The interest will be deductible currently but, with respect to some items of income, such as dividends, the inclusion of the income may be postponed to subsequent years. The same type of timing mismatch often occurs with respect to research and development expenses.

If foreign source income is exempt from residence country tax, in principle, any expenses incurred to earn such income should not be deductible. Many countries, however, allow the deduction of interest expense on borrowed funds used to acquire shares of foreign corporations, even though dividends received from such corporations are exempt from residence country tax. This issue has become increasingly important as more countries have adopted participation exemptions. The OECD's BEPS Action 4: *Interest Deductions and Other Financial Payments* (December 18, 2014) deals with this issue and is discussed in more detail in Chapter 7, section 7.2. Although expenses incurred to earn foreign source income that is taxable are deductible in computing a taxpayer's worldwide income, these expenses should also be deducted in computing foreign source income for purposes of the limitation on the foreign tax credit. This issue is also discussed further in Chapter 4, section 4.4.

3.2.4.2 Foreign Exchange Gains and Losses

Foreign source income is often earned in the currency of the country in which it is earned. Similarly, expenses incurred to earn foreign source revenue are often incurred in foreign currency. In a worldwide tax system, a resident's income must generally be reported in the currency of the country of residence. As a result, amounts of revenue and expense expressed in foreign currency must be translated into the domestic currency. In theory, each amount should be translated at the exchange rate applicable at the time that the amount is earned or incurred. For practical reasons, some countries allow amounts denominated in foreign currency to be translated into domestic currency using average exchange rates (monthly, quarterly, or annually).

For purposes of computing capital gains from the disposal of foreign property, it is appropriate to translate the cost of the property in foreign currency into domestic currency at the exchange rate applicable at the time that the property was acquired, and to translate the proceeds from the sale of the property at the exchange rate applicable at the time the property is sold. This method of foreign currency translation results in the recognition of the foreign currency gains and losses as part of the capital gain or loss from the disposal of the property, as illustrated in the following simple example.

Example

X, a resident of Country R, acquires property in Country S on October 20, 2000 at a cost of € 100,000, the currency of Country S. On October 20, 2000 the exchange rate of the

Euro relative to Country R's currency was € 1 = 1.5 Country R dollars. X sells the property on December 7, 2015 for € 100,000. The exchange rate relative to Country R dollars on that date is € 1 = 1 Country R dollar. The loss for purposes of Country R tax might be calculated as follows:

Proceeds	100,000	=	100,000 dollars
Cost	100,000	=	150,000 dollars
Loss			50,000 dollars

Because the dollar has appreciated against the Euro, the disposal of the property produces a loss, although in Euros there is no gain or loss. If the dollar had depreciated relative to the Euro (i.e., the exchange rate was € 1 = 1 dollar on October 20, 2000 and € 1 = 1.5 dollars on December 7, 2015) the taxpayer would have realized a gain of 50,000 dollars, although there would have been no gain or loss in terms of Euros.

An alternative method of calculating the gain or loss, which is similar but not as accurate, is to determine the gain or loss in the foreign currency (i.e., the cost and proceeds) and then translate that amount into domestic currency at the rate applicable on the date of sale, or perhaps the average rate applicable for the year in which the sale occurs. Under this approach, foreign exchange gains and losses are not realized at all. As shown in the previous example, there would be no gain or loss despite significant movement in the exchange rate.

Foreign exchange gains and losses may also arise with respect to debt obligations. For example, assume that a taxpayer resident in Country R, whose currency is R dollars, borrows € 1,000. At the time of the borrowing the exchange rate is € 1 = 5 R dollars. Interest on the loan is 10 percent annually. Each time that interest of € 100 becomes payable (or accrues or is paid), the taxpayer must convert that amount to R dollars at the exchange rate applicable at the time the interest becomes payable or is actually paid. When the loan is repaid, the taxpayer will realize a gain or loss depending on whether the R dollar has appreciated or depreciated in relation to the Euro. For example, if on repayment the exchange rate is € 1 = 4 R dollars, the taxpayer will realize a gain of 1,000 R dollars. In effect, the taxpayer has borrowed 5,000 R dollars, but needs only 4,000 R dollars to repay the loan. Under domestic law, foreign exchange gain or loss on the repayment or settlement of a debt obligation may be treated as a capital gain or loss or as ordinary income or loss.

Foreign currency risks arise with respect to actual foreign currency transactions and also with respect to other aspects of a taxpayer's business. For example, a taxpayer that sells its products to residents of another country is exposed to the risk that the country's currency may weaken against the taxpayer's currency, with the result that the taxpayer's products become more expensive for residents of the other country.

Businesses often try to manage or hedge their foreign currency risks through natural hedges, such as borrowing in the currency of the country in which they carry on business or own assets, or through derivatives, which are financial products designed to produce a gain or loss that offsets a gain or loss in respect of an underlying asset or liability. The treatment of these hedges for tax purposes is dependent on a

mixture of accounting rules and domestic tax law. Tax treaties do not generally deal with hedging.

3.2.4.3 The Treatment of Losses

Under a worldwide tax system, residents are taxable on their foreign source income. It follows that, in principle, they should be allowed to deduct any losses from foreign sources. Although this treatment of losses is consistent with the treatment of foreign source income from a theoretical perspective, it gives rise to problems, since taxpayers can manipulate the deductibility of business losses inappropriately. For example, a taxpayer will often commence business operations in a foreign country through a branch rather than a foreign subsidiary so that the start-up losses are deductible against the taxpayer's worldwide income in its country of residence. Once the business becomes profitable, the taxpayer can transfer the assets of the business to a foreign subsidiary - often on a tax-free basis - so that the future profits derived by the foreign subsidiary are not subject to tax by the taxpayer's country of residence, as explained in section 3.3.1 below.

If the residence country exempts some foreign source business income (e.g., business profits attributable to a foreign PE), then any foreign source losses attributable to a foreign PE should not be deductible in computing the taxpayer's worldwide income.

Some countries try to protect their tax base against the inappropriate deduction of foreign losses. Various rules are used for this purpose. For example:

- deductions for foreign source losses may be limited to a taxpayer's foreign source profits; and
- deductions for foreign source losses may be recouped if the foreign business is sold or transferred to a foreign subsidiary.

3.2.5 Tax Administration Issues

Taxing the foreign source income of residents presents special problems of administration and enforcement for the tax authorities of the residence country. The tax authorities require information concerning the taxpayer's foreign source income both to ensure that all of the income is reported and to verify that the income is properly computed. Typically, the tax authorities will attempt to obtain this information from the taxpayer in the first instance. Taxpayers may also be required to provide information about their foreign income-earning activities on a regular basis in their tax returns through information reporting returns, or pursuant to a specific request from the tax authorities. The tax authorities of the residence country may also obtain information from the tax authorities of the country where the income is earned by way of the exchange-of-information article of the tax treaty between the two countries. Exchange of information under tax treaties is discussed in Chapter 8, section 8.8.4.

Not surprisingly, taxpayers are sometimes tempted not to provide full disclosure to the tax authorities concerning their foreign source income because they know that it is much more difficult for the tax authorities to obtain information that is located outside the country than to obtain domestic information. Taxpayers may also be tempted to provide only favorable information. As a result, some countries have adopted rules to discourage this practice. Under these rules, if a taxpayer does not make full disclosure, the taxpayer is precluded from introducing any further information in any subsequent legal proceedings involving the foreign source income.

The tax authorities of one country are not generally allowed to visit another country for the purpose of auditing a taxpayer's reported foreign source income unless invited to do so by both the taxpayer and the foreign government. Thus, it is usually more difficult for the tax authorities to verify information provided by a taxpayer concerning its foreign activities. Some countries have entered into arrangements providing for joint audits in certain circumstances.

3.3 EXCEPTIONS TO WORLDWIDE TAXATION

3.3.1 Nonresident Companies and Other Legal Entities

Although countries are said to tax on a worldwide basis, the reality is quite different. In theory, if a resident of a country that taxes on a worldwide basis earns income from another country, that foreign source income will be subject to residence country tax. If, however, the resident establishes a foreign corporation or other foreign entity to earn the foreign source income, that income will not be subject to tax by the residence country in the absence of special rules such as **controlled foreign corporation (CFC) rules** or **foreign investment fund (FIF) rules.** The foreign entity is generally considered to be a separate taxable entity from the resident who owns it and, in most cases, the foreign entity will be considered to be a nonresident of the country in which the resident shareholder or owner resides. As a result, it is relatively easy, especially for corporations resident in a particular country, to avoid paying tax to that country on foreign source income through the use of foreign corporations or other legal entities such as trusts.

Example

Corporation A, resident in Country A, derives income of 1 million from business activities in Country B. The tax rate in Country B (20 percent) is lower than the rate in Country A (30 percent). As a result, Corporation A will pay tax to Country B of 200,000 on the income of 1 million derived from Country B. Assuming that Country A taxes on a worldwide basis, Corporation A will also pay Country A tax of 100,000 on the income of 1 million earned in Country B (300,000 less a credit for 200,000 of Country B tax). If Corporation A establishes a wholly owned subsidiary corporation in Country B and that subsidiary earns the income of 1 million from Country B that would have been earned directly by Corporation A, the subsidiary will pay 200,000 of Country B tax.

Corporation A will pay no tax to Country B or Country A until it receives dividends from the subsidiary or sells its shares of the subsidiary.

The immediate tax saving by Corporation A of 100,000 is easy and inexpensive to achieve; it simply requires the incorporation of a foreign corporation and the transfer of the income-earning assets to it. As a result, it is not surprising that the use of controlled foreign corporations and other foreign entities, such as trusts, as a tax-planning device is widespread. Nor should it be surprising that several countries have responded to such planning with rules to prevent the avoidance or deferral of domestic tax by the use of such foreign entities. These rules are discussed in Chapter 7, sections 7.3 and 7.4.

3.3.2 Temporary Residents

Some countries have special rules for temporary residents to relieve them of some of the more onerous aspects of residence taxation. Temporary residents are persons, such as corporate executives, who may be clearly resident in a country because their homes, families, and employment are located in the country but who intend to be, and are, resident only for a limited period, usually less than five years. As residents of the country, they become subject to all of that country's rules concerning the taxation of foreign source income; but because they are only temporarily absent from their home countries, these temporary residents often retain substantial economic interests there. The application of the full range of residence country rules to temporary residents can cause serious problems that may discourage talented persons from taking short-term postings in other countries.

Two specific examples may serve to illustrate the difficulties. Assume that an executive resident in Country A is a member of his company's pension plan. Under the tax law of Country A, the executive is entitled to deduct his contributions to the plan and is not taxable on the employer's contributions to the plan. Moreover, the income earned and accumulated in the plan is not taxable. However, distributions from the plan are taxable in full. Assume further that the executive takes a temporary posting in Country B, which does not allow any deduction for contributions to the pension plan and taxes the executive on the employer's contributions to the plan as a fringe benefit. Country B taxes distributions from the pension plan only to the extent that they exceed the employee's and employer's contributions to the plan. The executive plans to retire in Country A. To the extent of contributions to the plan while he was resident in Country B, the executive will be subject to double taxation: once in Country B when the income was earned, because he was taxed on the employer's contributions to the plan and not allowed any deduction for his own contributions, and again in Country A when he receives distributions from the plan. This double taxation is clearly unfair and should be eliminated.

As a second example, assume that A, a resident of Country A, establishes a trust under the laws of Country A for the benefit of his children. Country A taxes the income accumulating in the trust, but at the tax rates applicable to the children. A moves to Country B to take a temporary position for a few years and becomes subject to special

rules in Country B for residents who have established foreign trusts. Most likely, A did not establish the trust to avoid Country B tax because at the time the trust was established he may not have known that he would be moving to Country B. Under Country B's rules, A is taxable on the income of the foreign trust even though the trust is taxable on its income in Country A. To eliminate this double taxation, some countries exempt temporary residents from their foreign trust and foreign investment fund rules for a limited period of time.

3.4 SPECIAL ISSUES

3.4.1 Exit or Departure Taxes

When a person ceases to be resident in a country that taxes residents on their worldwide income, the person will no longer be subject to tax on worldwide income in that country. The consequences of ceasing to be resident are not, however, quite so simple. What if, for example, the person owns shares of a resident corporation that are worth significantly more than when they were acquired? Under most tax treaties, capital gains derived by a taxpayer resident in one country from the disposal of shares of a company resident in the other country are taxable only by the country in which the taxpayer is resident (unless the value of the shares is attributable primarily to immovable property located in the country). Therefore, if the person moves to another country that has a treaty with his former country of residence, the shares can be sold without any tax imposed by the former residence country. If the new country of residence has been chosen carefully, it may not impose any tax, or little tax, on the gain realized on the sale of the shares. Not surprisingly, the person's former country of residence is unlikely to be pleased about the result.

Several countries have adopted special rules, often called **exit** or **departure taxes**, to prevent the avoidance of domestic tax by departing residents. Countries that have adopted exit taxes applicable to all property include Australia, Canada, and Norway. Other countries, such as France, Germany and the Netherlands, have more limited exit taxes that apply only to certain shares in resident companies. The United States (US) has an even more limited exit tax that applies only to transfers of tangible property out of the US by US citizens who give up US citizenship and US permanent residents (green card holders) who give up that status.

Typically, these taxes operate by requiring the departing resident to pay tax not only on the income and gains realized up to the date that the taxpayer ceases to be resident, but also on any accrued but unrealized income or gains. For example, assume that X, a resident of Country X, ceases to be resident on September 30, 2016. At that time X's worldwide income from January 1, 2016 to September 30, 2016 is 70,000. X also owns shares of a company that he started several years ago and which is now very successful. The shares currently have a value of 30 million. The cost of the shares to X is nominal. X also owns an interest-bearing bond issued by a company resident in Country X. The interest on the bond is payable annually on December 31. If Country X does not impose any tax on departing residents, X will not pay tax on the accrued gain

on the shares or the interest accrued to September 30 on the bond. When X sells the shares or receives the bond interest after September 30, 2016, he will no longer be resident in Country X. Even if Country X imposes tax on nonresidents deriving interest from Country X and realizing capital gains on shares in companies resident in Country X, there may be a tax treaty between Country X and X's new country of residence.

Typically, tax treaties based on the OECD or UN Model Treaties preclude a country from taxing residents of the other country on capital gains from disposals of shares of resident companies unless the assets of the companies consist primarily of immovable property located in the country. Treaties also typically limit the tax imposed by a country on interest paid to a resident of the other country to 10 or 15 percent, which may be significantly less than the rate of tax applicable to interest derived by residents.

To avoid these results, Country X may decide to impose an exit or departure tax on persons ceasing to be resident. Under these rules, X will be deemed to have disposed of his shares for their market value and to have received the interest accrued on the bond immediately before ceasing to be resident. These amounts would be included in X's worldwide income for the period ending on September 30, 2016 and would be subject to tax in Country X. The treaty with X's new country of residence would not apply to preclude Country X from taxing X on these amounts as long as Country X's tax is imposed on income derived or deemed to be derived at a time when X is still a resident of Country X.

Special problems are encountered with departure taxes. Most important, the taxpayer will often not have the funds to pay the tax because the income has not actually been received or the property has not actually been sold. Accordingly, some countries allow the departing resident to defer the payment of the tax if appropriate security for the ultimate payment of the tax is provided. A departure tax may also cause serious problems of double taxation. Most countries without departure taxes measure the amount of a gain on the disposal of property as the difference between the sale proceeds and the historical cost of the property. If a taxpayer ceases to be resident in a country that levies a departure tax, the taxpayer will be subject to tax on the accrued gain in respect of capital property owned at the time of departure. The accrued gain is the amount of the value of the property immediately before departure (e.g., 1,000) in excess of the historical cost of the property (e.g., 200), so that the accrued gain is 800. When the taxpayer sells the property at a future date, the taxpayer's new country of residence will usually tax the entire gain (e.g., 1,800 computed as proceeds (2,000) less historical cost (200)) and not just the portion of the gain (1,000) that was not taxed by the former country of residence. Thus, a portion of the gain may be subject to double taxation. In this situation, under the provisions of a typical tax treaty, neither country is obligated to provide relief for the other country's tax because both countries impose tax on the basis of the taxpayer's residence (but for different years so that the tiebreaker rules for dual residents do not apply).

Countries that impose departure taxes often deem taxpayers becoming resident to have acquired property owned at that time for its market value. In effect, the taxpayer is given a step-up in the cost of the property for tax purposes from its historical cost to its value at the time the taxpayer becomes resident. The overall result of this step-up in

cost and the departure tax is that the country taxes only gains and losses accrued while a taxpayer is resident; gains and losses accruing before a taxpayer becomes resident or after a taxpayer ceases to be resident are not taxable.

3.4.2 Trailing Taxes

An alternative or supplement to an exit tax that some countries have adopted is a so-called **trailing tax**. Under a trailing tax, a country imposes tax on all or certain items of income of a resident even if the resident ceases to be a resident under the country's ordinary rule for determining residence. These trailing taxes take a wide variety of forms and may be broad or narrow in scope. For example, some countries, such as Germany, have special rules under which former residents who move to designated tax havens continue to be subject to tax on their entire income as deemed residents. The US has a similar rule for US citizens who give up their US citizenship for the purpose of avoiding US tax. Such former US citizens continue to be subject to US tax for ten years after they renounce their US citizenship.

One common type of trailing tax applies to capital gains. As noted above in connection with exit taxes, residents of high-tax countries may avoid tax on accrued capital gains by shifting their residence to a country that does not tax capital gains, or taxes them at a low rate, and then disposing of the property. An exit tax on departing residents captures only the gain accrued to the date that the taxpayer ceases to be resident. Under a trailing tax, the taxpayer would be subject to tax on the entire gain if property owned at the time the taxpayer ceased to be resident is disposed of within a certain period after the taxpayer ceases to be a resident (typically five to ten years). The basic operation of a trailing tax on capital gains of former residents of a country and the relationship between a trailing tax and an exit tax is shown in the following example.

Example

Country A imposes tax on capital gains at a rate of 15 percent; however, Country A does not impose tax on capital gains (other than gains from the disposition of immovable property located in Country A) realized by nonresidents. A, a resident of Country A, owns shares of a company resident in Country A that originally cost 1 million and now have a value of 10 million. If A moves from Country A to Country B, which does not tax capital gains, A can avoid Country A's capital gains tax on the 9 million accrued gain. In order to prevent this type of tax avoidance, Country A may adopt a trailing tax. This trailing tax would tax any capital gains in respect of property owned by former residents at the time they cease to be resident if the property is disposed of within five years after they cease to be resident. Therefore, under the trailing tax, if A disposes of the shares for 13 million within five years of ceasing to be resident in Country A, the entire 12 million gain would be subject to tax by Country A.

If Country A has an exit tax, A's accrued capital gain of 9 million at the time of A's departure from Country A would be subject to Country A tax at the time A ceases to be resident in Country A. When A sells the shares for 13 million, say, four years later, a capital gain of 3 million (proceeds of 13 million less deemed cost of 10 million) would

be subject to tax under Country A's trailing tax. However, if A waits for more than five years after ceasing to be resident in Country A to sell the shares, the trailing tax would not apply.

The application of a country's trailing taxes will be prevented by any tax treaties that the country enters into unless those treaties contain special provisions allowing the imposition of such a trailing tax. Article 13 of the OECD and UN Model Treaties does not allow the imposition of trailing taxes on capital gains realized by former residents. Therefore, on the facts of the preceding example, if Country A and Country B have a tax treaty with an article dealing with capital gains similar to Article 13 of the OECD or UN Model Treaties at the time of the sale of the shares, A would be entitled to the benefits of the treaty as a resident of Country B. Country A would not be entitled to tax A's capital gain from the sale of the shares (unless the value of the shares was derived primarily from immovable property situated in Country A or the shares represent a substantial interest in the company (UN Model Treaty only)). Some countries put special provisions in their tax treaties to allow them to impose trailing taxes on certain capital gains.

Some countries, such as the United Kingdom (UK), impose tax on former residents who resume their residence within a relatively short period (five years in the case of the UK). The tax applies to capital gains realized during the taxpayer's nonresidence but applies only on the resumption of UK residence.

3.4.3 Resident for Part of a Year

Special rules may be necessary if a taxpayer is a resident of a country for only part of a year. A taxpayer could be subjected to tax on worldwide income for the entire year if the taxpayer is resident at any time during the year. This result seems harsh, especially if the taxpayer's new country of residence follows the same practice, although the dual-residence tiebreaker rules in tax treaties may provide relief in some circumstances. As a result, some countries have rules to tax part-time residents on their worldwide income for only the portion of the year during which they are actually resident. These rules may be difficult to apply with respect to certain types of income, such as business income, that are usually calculated on an annual basis. A taxpayer's personal deductions, allowances, and credits are usually prorated to reflect the portion of time during the year that the taxpayer is actually resident. In theory, the taxpayer's new country of residence should provide the taxpayer with personal allowances for the balance of the year.

The problems of part-time residents are different from those of **deemed residents**. For example, as discussed in Chapter 2, section 2.2.1, many countries have **183-day rules** under which persons who are present in the country for more than 183 days in any year are deemed to be residents. These residents are typically deemed to be resident for the entire year, not just for the portion of the year during which they are present in the country. However, part-time residents are resident for part of a year and nonresident for the remainder of the year.

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[illegible] resident [illegible] only part [illegible] for the entire year [illegible] seems harsh, especially [illegible] although [illegible] be some circum [illegible] particular residents on their [illegible] year [illegible] which they are actually [illegible] certain types of income [illegible] annual basis [illegible] [illegible] generally prorated to reflect the [illegible] the tax [illegible] allowance for the [illegible] year.

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CHAPTER 4

Double Taxation Relief

4.1 INTRODUCTION

As discussed in Chapter 2, most countries tax their residents on their worldwide income and nonresidents on their domestic source income. Consequently, foreign source income earned by a resident of a country may be taxed by both the country in which the income is earned (the source country) and the country in which the taxpayer is resident (the residence country). If income tax rates are low, as they were in the early years of the last century when income taxes were in their infancy, the inefficiencies and unfairness caused by this double taxation may be tolerable. But when tax rates reach the levels that now prevail, double-tax burdens can become onerous and interfere substantially with international commerce. The necessity for the relief of international double taxation is clear on grounds of equity and economic policy. However, the type of relief that is appropriate is a controversial question.

International double taxation can arise in a variety of ways. The following three types of double taxation arise from overlapping claims by two or more countries to tax the same income:

- *Source-source claims.* Two countries assert the right to tax the same income of a taxpayer because they both claim that the income is sourced in their country.
- *Residence-residence claims.* Two countries assert the right to tax the same income of a taxpayer because they both claim that the taxpayer is a resident of their country. A taxpayer that is a resident of two countries is commonly referred to as a "dual-resident taxpayer".
- *Residence-source claims.* One country asserts the right to tax foreign source income of a taxpayer because the taxpayer is a resident of that country, and another country asserts the right to tax the same income because the income arises or has its source in that country.

Of these three types of international double taxation, overlapping residence-source claims are the most likely to occur. To some degree, taxpayers can minimize their exposure to the other types of double taxation through careful tax planning, but residence-source double taxation is difficult for taxpayers to avoid through tax planning. Therefore, the attempts of the international tax community to deal with international double taxation have focused primarily on the elimination of residence-source conflicts.

International double taxation can also occur due to differences in the way countries define income and in the timing and tax accounting rules they adopt for computing income. As explained in Chapter 6, international double taxation may also occur due to disputes between countries about the proper arm's-length prices for cross-border transfers of goods and services between related parties. Other rules adopted to curtail tax avoidance can also produce double taxation. For example, if one country denies the deduction of interest paid by a resident corporation to a shareholder in another country pursuant to **thin capitalization rules** and treats the interest paid as a dividend, the amount may be taxable in both countries, as a dividend subject to withholding tax in one country and as interest included in a resident's income by the other country.

Typically, tax treaties provide relief from the three major types of international double taxation, and from some of the other types as well, although the relief is sometimes limited. Some cases of double taxation resulting from overlapping claims based on the source of income are dealt with by explicit rules for the source of income. For example, Article 11(5) of the OECD and UN Model Treaties provides a rule that interest is deemed to arise (i.e., have its source) in the country in which the payer is resident. As noted in Chapter 2, section 2.3.1, however, most tax treaties do not contain extensive source rules. Cases involving source-source double taxation that are not resolved by the specific provisions of a treaty may be resolved through consultation between the competent authorities of the two treaty countries under the treaty's mutual agreement procedure. See Chapter 8, section 8.8.3 for a discussion of the mutual agreement procedure. Resolution of such issues is not easy because the competent authorities of most countries are naturally reluctant to give up their country's right to tax domestic source income.

Individual taxpayers almost always obtain relief from international double taxation resulting from dual residence through the tiebreaker rules in tax treaties. Cases involving the dual residence of legal entities are also resolved by treaty. As discussed in section 2.2.3, Article 4(2) of the OECD and UN Model Treaties provides a series of "tie-breaker" rules to resolve cases in which an individual is resident in both countries. The dual residence of a legal entity is resolved under Article 4(3) the OECD and UN Model Treaties by deeming the entity to be resident in the country where its place of effective management is located. The mutual agreement procedure is sometimes used to deal with dual-residence cases that are not resolved explicitly in the treaty. Since dual-resident entities are often used to avoid tax, some bilateral tax treaties deny treaty benefits to such entities.

Ordinarily, the residence country grants relief from double taxation resulting from the imposition of tax on the same item of income by both the residence country

and the source country. In other words, the source country's right to tax on the basis of the source of the income has priority over the residence country's right.

Three methods - the **deduction method**, the **exemption method**, and the **credit method** - are commonly used for providing relief from double taxation. These methods are discussed in section 4.3 below after a brief explanation of what is meant by the term "international double taxation".

4.2 INTERNATIONAL DOUBLE TAXATION DEFINED

The term "double taxation" is used in so many different contexts that any precise definition of the term is not appropriate in all contexts. The term is not defined in the OECD or UN Model Treaties or in the Commentary on those Models, although they identify one of their main objectives as "the avoidance of double taxation with respect to taxes on income and on capital".

"*International double taxation*" can be defined as the imposition of income taxes by two or more sovereign countries on the same item of income (including capital gains) of the same taxable person for the same period. This juridical or legal definition of international double taxation is narrow and does not cover many situations that commentators frequently refer to as double taxation, although it does identify the essential ingredients of international double taxation. Even so, under this definition, it is not always easy to determine whether double taxation exists in a particular case. For example, questions may arise as to whether the taxes levied by the two countries are both income taxes or whether the items of income subject to tax are the same.

The legal definition of international double taxation should be distinguished from the broader economic concept of double taxation. Economic double taxation occurs whenever there is multiple taxation of the same item of economic income. Under the legal definition, taxation of a subsidiary company by one country and taxation of the parent company on a dividend from that subsidiary by another country is not international double taxation because the two companies are separate legal entities. In the economic sense, however, the parent and the subsidiary constitute a single enterprise. Economic, but not legal, double taxation also may arise when income is taxed to a partnership and to the partners or when it is taxed to a trust and to the beneficiaries of the trust.

Methods for relieving international double taxation are primarily focused on legal double taxation rather than economic double taxation. The reason double taxation relief is limited to legal double taxation is that the definition of economic double taxation is exceedingly broad and difficult to specify with the precision needed for tax laws. For example, some economic double taxation occurs when income is taxed when earned and again when consumed, yet no country is prepared to extend double taxation relief to sales taxes or other consumption taxes. Similarly, countries are not prepared to grant relief from the economic double taxation resulting from the imposition of both an income tax and an estate or wealth tax. However, double taxation relief is sometimes extended to economic double taxation where taxes are paid by foreign

subsidiaries and other foreign affiliates of a resident parent corporation despite the fact that the taxes are not paid by the parent.

International double taxation should be distinguished from the double taxation of an item of income by a single country, which might be termed "domestic double taxation". Domestic double taxation may arise, for example, with respect to income earned by a corporation and distributed to its domestic shareholders under the so-called **classical method** of corporate taxation. It may also arise when tax is imposed on the income of a person by both the central government of a country and one or more of its political subdivisions. Double taxation by national and sub-national governments is not necessarily objectionable - indeed, when the levels of taxation are properly regulated to avoid excessive tax burdens, such double taxation may be an inevitable feature of fiscal federalism.

4.3 RELIEF MECHANISMS

No international consensus has been reached on the appropriate method for granting relief from international double taxation. The following three methods are in common use. Most countries use all three methods for different types of international double taxation; a country may use only one of these methods, or it may use some combination of methods:

- *Deduction method.* The residence country allows its taxpayers to claim a deduction in computing income for taxes, including income taxes, paid to a foreign government in respect of foreign source income.
- *Exemption method.* The residence country exempts foreign source income derived by its residents from residence country tax.
- *Credit method.* The residence country provides its resident taxpayers with a credit for income taxes paid to a foreign country against residence country taxes otherwise payable. Under the credit method, foreign taxes are deductible in computing the tax payable to the residence country but not in computing the taxpayer's income.

Foreign source income earned by residents of a country that uses the deduction method is taxable at a higher effective rate than it would be under either the credit method or the exemption method. The exemption method and the credit method typically give equivalent results whenever the effective foreign tax rate is equal to or greater than the domestic effective tax rate. The exemption method is generally the most favorable to the taxpayer when the foreign effective tax rate is less than the domestic effective tax rate. The basic results under the three methods are illustrated by the following example.

Example

R, a resident of Country A, earns 100 of income from Country B on which she pays 40 of tax to Country B. Under the *deduction method,* R will pay tax to Country A on net income of 60 (100 - 40). The foreign tax paid to Country B of 40 is deductible in

computing R's income subject to tax in Country A. Assuming that R is taxable in Country A at a rate of 50 percent, she will pay tax of 30 to Country A and a total tax of 70 on her income of 100, for a combined foreign and domestic rate of 70 percent. If Country A uses the *credit method,* R's tax liability to country A (before any foreign tax credit) will be 50 percent on her total worldwide net income (100) with no deduction for the taxes paid to Country B. However, she will receive a credit against the tax otherwise payable to Country A for the taxes paid to Country B of 40. The foreign tax paid of 4 is deductible against the tax payable to Country A. The result is that R will pay tax to Country A of only 10 (50 - 40) and total tax of 50, for a combined foreign and domestic effective tax rate of 50 percent. Finally, if Country A uses the *exemption method,* R will pay no tax to Country A in respect of the foreign source income earned in Country B, and the total tax payable on the income will be 40, for a combined foreign and domestic rate of 40 percent. These results are summarized in Table 4.1.

Table 4.1 Comparison of Methods for Relieving Double Taxation

	Deduction Method	*Credit Method*	*Exemption Method*
Foreign source income	100	100	100
Foreign tax (40%)	40	40	40
Deduction for foreign tax	40	nil	nil
Net domestic income	60	100	nil
Domestic tax before credit (50%)	30	50	nil
Less: foreign tax credit	nil	40	nil
Final domestic tax	30	10	nil
Total domestic and foreign tax	70	50	40

Additional information on the operation of the deduction, exemption, and credit methods is provided below in sections 4.3.1, 4.3.2, and 4.3.3, respectively, and the exemption and credit methods are compared in section 4.3.4. Section 4.3.5 examines some of the effects of tax treaties on double-taxation relief.

4.3.1 Deduction Method

Countries using the deduction method tax their residents on their worldwide income and allow those taxpayers to take a deduction for foreign taxes paid in the computation of their taxable income. In effect, foreign taxes - income taxes and other types of taxes - are treated as costs or current expenses of doing business or earning income in the foreign jurisdiction. As noted above, the deduction method is the least generous method of granting relief from international double taxation.

The deduction method was used by a number of countries in the formative years of their tax systems when worldwide tax rates were low, and at that time it was an acceptable approach. As tax rates increased in the post-World War II period, however,

most countries adopted either the exemption method or the credit method as the basic method for relieving international double taxation. The OECD and UN Model Treaties authorize only the exemption method and credit method as methods for granting double-tax relief.

The deduction method has not disappeared. Several countries that have adopted the credit method have retained the deduction method as an optional form of relief and as a way of dealing with foreign taxes that, for some reason, do not qualify for the foreign tax credit. In addition, some countries use the deduction method for taxes paid with respect to income derived from foreign portfolio investments.

In effect, countries use the deduction method whenever they tax residents on the net amount of the dividends they receive from a foreign corporation, assuming that the foreign corporation has paid some foreign income tax and a foreign tax credit is not allowed with respect to that tax. For example, assume that FCo, a foreign corporation, earns 100 of foreign income and pays foreign income tax of 20. FCo pays its remaining after-tax income of 80 as dividends to its shareholders, including a dividend of 20 to R, a resident of Country A who owns 25 percent of the shares of FCo. On these facts, R has earned 25 of foreign source income through FCo on which foreign income tax of 5 (25 percent × 20) is paid. If Country A taxes R on income of 20, it is in effect allowing R a deduction for the 5 of income tax that was paid by FCo. A country that requires the associated tax to be added to net dividends is said to "**gross up**" the dividends to approximate the before-tax income out of which the dividends were paid. The purpose of a gross-up rule is to provide equivalent treatment to taxpayers earning foreign income directly and taxpayers earning such income indirectly through a foreign corporation. See the discussion of the **indirect foreign tax credit** in section 4.3.3.3 below.

The effect of the deduction method is that residents earning foreign source income and paying foreign income taxes on that income are taxable at a higher combined tax rate than the rate applied to domestic source income. As a result, the deduction method creates a bias in favor of domestic investment over foreign investment whenever the foreign investment is likely to be subject to foreign income tax. Thus, the deduction method is not neutral with respect to the allocation of resources between countries. This treatment may be justified from the viewpoint of national self-interest: not only is domestic investment encouraged, but also residents with equal net worldwide income are treated similarly in that they will pay the same amount of domestic tax. Of course, from the perspective of the total (combined domestic and foreign) tax burden on a taxpayer's worldwide income, the deduction method does not achieve equal treatment of residents. Although residents with equal net worldwide income will pay the same domestic tax, they may pay widely differing amounts of foreign tax.

4.3.2 Exemption Method

Under the exemption method, the country of residence taxes its residents on their domestic source income and exempts them from domestic tax on some or all of their

foreign source income. In effect, the country of residence gives up its right to tax foreign source income, which consequently is taxable exclusively by the source country. The exemption method completely eliminates residence-source international double taxation because only one jurisdiction, the source country, imposes tax on the income.

Some countries - Hong Kong is a prominent example - have adopted the exemption method with respect to most or all foreign source income earned by their residents. In effect, these countries tax only income from domestic sources. For this reason, they are often said to tax on a territorial basis rather than a worldwide basis. For most countries using the exemption method, however, the exemption of foreign source income is limited to certain types of income, most commonly business income earned in foreign countries and dividends from foreign affiliates. Further, the exemption method is sometimes restricted to income that has been subject to tax, or subject to a minimum rate of tax, by the foreign country.

Although foreign source income may be exempt from residence country tax by countries using the exemption method, the income may be taken into account in determining the rate of tax applicable to the taxpayer's other taxable income. This practice is referred to as "exemption with progression." In such systems, the foreign source income is included in income for the limited purpose of determining a taxpayer's average tax rate as if the foreign income were taxable; this average rate is then used to compute the actual tax due on the taxpayer's other (non-exempt) income. Several countries, including Belgium, Finland, Germany, and the Netherlands, use the exemption with progression method.

Example

Assume that Country A levies tax at a rate of 20 percent on the first 10,000 of income and 40 percent on income in excess of 10,000. T, a taxpayer resident in Country A, has 10,000 of domestic source income from Country A and 10,000 of exempt foreign source income. T would pay tax of 2,000 (20 percent of 10,000) under a regular exemption system. Under an exemption with progression system, T must determine the average tax rate that would apply if his entire income of 20,000 were domestic source income. In this example, the average rate would be 30 percent ((10,000 × 0.20 + 10,000 × 0.40) divided by 20,000). The tax payable to Country A would then be determined by applying the 30 percent average rate to the domestic source income of 10,000, resulting in tax payable of 3,000.

The exemption method is relatively simple for the tax authorities to administer and is effective in eliminating international double taxation. The exemption with progression system is more complex because it requires the tax authorities to obtain information about the amount of foreign source income earned by resident taxpayers.

Although the exemption method is widely used and is sanctioned by both the OECD and UN Model Treaties (see Article 23A of both treaties), it is inconsistent with the tax policy objectives of fairness and economic efficiency. To the extent that foreign taxes are lower than domestic taxes, resident taxpayers with exempt foreign source income are treated more favorably than other residents. Moreover, an exemption system encourages resident taxpayers to invest abroad in countries with lower tax rates, especially in tax havens, and encourages them to divert domestic source income

to such countries. For example, a taxpayer residing in an exemption country who earns interest on funds invested in that country has a strong incentive to move the funds to a foreign country that imposes low or no taxes on interest income.

Because of these deficiencies, as noted above, the application of the exemption method for relieving double taxation to all foreign source income, which is equivalent to taxing on a territorial basis, is difficult to justify and is used by only a few countries. The exemption method can be justified if it is used as a convenient and simple proxy for the credit method or is limited to certain types of income. For example, a country might exempt resident taxpayers on income derived from foreign countries that impose tax at rates and under conditions that are roughly comparable to its own rates and conditions. If such an exemption system is properly enforced, the results are similar to those obtained under a credit system because, in such circumstances, a country using the credit method would collect little or no tax with respect to any foreign source income that is subject to foreign tax comparable to the residence country's tax. This point is illustrated in the following example.

Example

ACo is resident in Country A, which levies income tax at a rate of 40 percent. ACo earns income of 1,000 in each of Country B and Country C, which levy tax at rates of 40 and 50 percent respectively. Country A has a foreign tax credit system to relieve international double taxation. Consequently, the credits for taxes paid to Countries B and C, 400 and 500 respectively, will completely offset Country A's tax of 800 on ACo's total foreign source income of 2,000. Country A will collect tax from ACo after allowing the credit for foreign taxes only if ACo's effective foreign tax rate is less than the effective tax rate of Country A.

Of course, in the example above, the effective foreign tax rate may be lower than the Country A rate even if Country B and Country C generally impose substantial taxes on foreign corporations. For example, one or both countries may offer some special tax incentives or their tax laws may contain some loopholes that foreign corporations are able to exploit. In such circumstances, Country A might collect some tax revenue from ACo in respect of its foreign source income.

Several countries use the exemption method for active business income earned by resident corporations through a foreign branch or permanent establishment. Several countries also exempt certain dividends received from foreign corporations in which resident corporations have a minimum ownership interest, usually 5 or 10 percent. This exemption for dividends is often referred to as a **participation exemption** and is discussed in more detail in section 4.3.3.1 below.

The alleged virtue of the exemption method for relieving international double taxation is its simplicity: it minimizes compliance costs for taxpayers and administrative costs for tax authorities. However, for an exemption system to operate effectively, a country must be able to ensure that the exemption is limited to foreign source income that is subject to foreign tax comparable to domestic tax. Thus, an effective exemption system requires vigorous source-of-income and expense rules. It also requires anti-avoidance rules to prevent low-taxed foreign source income from qualifying for exemption. Finally, it requires expense allocation rules or anti-avoidance rules to

prevent taxpayers from deducting expenses incurred to earn exempt foreign source income against their domestic income.

One often-overlooked weakness of an exemption system is its likely impact on the shifting of tax burdens from an income earner to the payer in some circumstances. Assume, for example, that Country A, which has a corporate tax rate of 50 percent, provides an exemption for foreign source income. Country B imposes a withholding tax of 25 percent on interest payments made to nonresidents. ACo, a resident of Country A, makes a loan of 100,000 to BCo, a resident of Country B. If ACo can earn 10,000 of interest free of tax by loaning money to a resident of Country C instead of BCo, ACo is likely to demand that it receive annual payments of 10,000, net of Country B's withholding tax from BCo. Therefore, BCo must gross up its payments to ACo so that ACo ends up with 10,000 after Country B's 25 percent withholding tax. The effect of this arrangement is that the burden of the withholding tax of 2,500 imposed by Country B on the payment to ACo is borne by BCo. This economic effect would be avoided if Country A used the credit method. In that case, ACo would pay taxes of 5,000 wherever it earned the 10,000 of interest income. ACo would have no leverage to shift Country B's withholding tax to BCo because it would have no opportunity for earning 10,000 free of tax and Country B's withholding tax would be creditable against ACo's tax payable to Country A.

4.3.2.1 Participation Exemption

Most foreign direct investment takes the form of equity or share investments in foreign or nonresident corporations. Special considerations apply to the relief of international double taxation with respect to dividends from foreign corporations and capital gains from the disposition of shares of foreign corporations. This section discusses the exemption of dividends and capital gains with respect to substantial participations in foreign corporations. The indirect or underlying foreign tax credit for dividends from foreign corporations is discussed in section 4.3.3.3 below. The participation exemption and the indirect credit are compared in section 4.3.4.

Several countries use the exemption method to eliminate the double taxation of dividends from foreign corporations. The exemption method has been the traditional method used by European countries; however, in recent years Australia, Japan, and the United Kingdom have also adopted participation exemptions. The United States (US) has been discussing the possible adoption of an exemption for dividends for many years, but has not yet done so.

There are 3 key elements in the design of a participation exemption:

- the level of share ownership necessary to qualify for the exemption;
- the nature of the income earned by the foreign corporation out of which the dividends are paid; and
- the amount of foreign tax on the income of the foreign corporation.

These same three elements are also important in the design of an indirect foreign tax credit, as discussed in section 4.3.3.3.

The participation exemption is limited to dividends received by a resident corporation from a foreign corporation in which the resident corporation has a substantial ownership interest or participation. The level of share ownership required varies from 5 percent (e.g., in the Netherlands) to 25 percent (e.g., in Japan) and in the Parent-Subsidiary Directive in the EU. Many countries use a 10 percent ownership threshold. The ownership threshold can be based on voting shares, the value of shares (or both votes and value) or all the shares of the foreign corporation.

In theory, an exemption for dividends should be limited to dividends out of the active business income earned by a foreign corporation. Dividends out of passive investment income should not qualify for exemption; otherwise, resident corporations would have an incentive to divert passive income to their foreign subsidiaries in order to reduce residence country tax. For example, assume that ACo, a company resident in Country A, has funds available for investment that could earn passive income of 1 million. If ACo earns the income by investing in Country A, it will pay tax to Country A of 40 percent. However, if ACo uses the funds to acquire shares in its wholly owned subsidiary, BCo, resident in Country B, which taxes at a rate of only 10 percent, and BCo earns passive income of 1 million, BCo will pay tax to Country B of 100,000. BCo can then distribute its after-tax profits of 900,000 to ACo. Assuming that Country A exempts the dividend, this simple tax planning would result in substantial tax savings for ACo.

Therefore, some countries limit the exemption to dividends out of active business income of foreign affiliates. Such an approach imposes significant compliance obligations on taxpayers to keep track of the type of income earned by their foreign affiliates and requires rules to determine the type of income from which dividends are considered to be paid. As a consequence of these problems, some countries have abandoned any attempt to limit their participation exemptions to dividends paid out of active business income of foreign affiliates of resident corporations, and instead rely on CFC rules or other anti-avoidance rule to prevent the abuse of the participation exemption. For example, under CFC rules, any passive income earned by a controlled foreign affiliate of a resident corporation is taxable to the resident corporation when earned by the controlled foreign affiliate without waiting for the income to be distributed in the form of a dividend. If the passive income is taxable to the resident parent corporation when earned, any subsequent dividend out of that income can be exempt from tax. CFC rules are discussed in Chapter 7, section 7.3.

As noted above, if the income of a foreign affiliate in which a resident corporation has a substantial participation is subject to foreign tax at a rate that, when combined with any withholding tax on dividends, approximates the tax rate imposed by the residence country, the residence country will not collect any tax on dividends from foreign affiliates in that country even if it uses the credit method. Therefore, from a theoretical tax policy perspective, a participation exemption can be justified as a proxy for a foreign tax credit if the exemption is limited to dividends out of income that is subject to foreign tax (corporation tax and dividend withholding tax) at a rate that is comparable to the residence country's corporate tax rate.

Some countries have limited their participation exemptions to dividends from foreign affiliates established in listed comparable-tax countries or to countries with

which they have concluded bilateral tax treaties that provide an exemption for dividends. In the interests of simplicity, other countries have abandoned any attempt to limit their participation exemptions to dividends that are paid out of income that has been subject to foreign tax comparable to residence country tax. In these countries, the participation exemption is available even for dividends from foreign affiliates in low-tax countries. Most of these countries rely on other rules, such as CFC rules, to prevent abuses of the participation exemption. As noted above, if the income of a CFC is taxable to its resident parent corporation when earned, any subsequent dividends out of that income can be exempt from residence country tax.

Some countries with a participation exemption for dividends from foreign affiliates also extend the exemption to capital gains on the disposition of the shares of those foreign affiliates. The rationale for extending the participation exemption to capital gains is that, from an economic and commercial perspective, dividends are often a substitute for capital gains with respect to substantial participations. Thus, if dividends from a foreign affiliate are exempt from tax by the country in which the shareholder corporation is resident but capital gains on the sale of the shares of a foreign affiliate are not exempt, the shareholder corporation can reduce the capital gain from the sale of the shares of a foreign affiliate by requiring it to pay exempt dividends before the sale.

For example, assume that ACo, resident in Country A, owns all of the shares of BCo, resident in Country B. Country A has a participation exemption for dividends from foreign corporations in which resident corporations own at least 10 percent of the shares (by votes and value). However, Country A imposes a tax of 20 percent on capital gains, including capital gains from the disposal of shares of foreign corporations. ACo is contemplating a sale of the shares of BCo to an arm's length purchaser and expects to make a capital gain of 10 million (proceeds of sale of 14 million less the cost of the shares (4 million)). The gain would be subject to tax by Country A of 20 percent of 10 million, or 2 million. If BCo pays a dividend of 10 million to ACo before the sale, the dividend will reduce the value of the shares, the proceeds of sale and the capital gain. However, the dividend may be subject to withholding tax by Country B. If so, the payment of dividends to reduce the capital gain would be beneficial only to the extent that the source country's withholding tax is less that the residence country's tax on the capital gain.

4.3.3 Credit Method

Under the credit method, foreign taxes paid by a resident taxpayer on foreign source income generally reduce domestic taxes payable on that income by the amount of the foreign tax. For example, if P pays a foreign tax of 10 on some foreign source income and would otherwise be subject to domestic tax of 40 on that income, the foreign tax credit reduces the domestic tax payable from 40 to 30. Consequently, the credit method completely eliminates international double taxation of the residence-source type. Under the credit method, foreign source income is subject to domestic tax whenever the foreign tax paid is less than the domestic tax payable. In such circumstances, the

net domestic tax is an amount equal to the foreign source income multiplied by the difference between the two tax rates. In effect, assuming that the domestic tax rate is lower than the foreign tax rate, the foreign taxes are "topped up" by domestic taxes so that the combined domestic and foreign tax rate on the foreign source income is equal to the domestic tax rate.

Invariably, credit countries do not refund foreign taxes paid by their residents on foreign source income in excess of the domestic tax on that income; see, for example, Article 23B of the OECD and UN Model Treaties. Similarly, countries with foreign tax credit systems do not generally allow excess foreign taxes to offset taxes imposed on domestic income. In other words, the credit for foreign taxes paid is usually limited to the amount of the domestic tax payable on the foreign source income. Various limitation rules, sometimes quite complex in application, as discussed below, are used to prevent what are perceived to be inappropriate uses of foreign tax credits. As a result of these limitations on the credit, foreign income is typically taxed at the foreign tax rate whenever the foreign rate is higher than the domestic rate. In summary, under the credit method, foreign source income earned by residents is generally taxed at the higher of the domestic and foreign tax rates.

4.3.3.1 General Rules

The credit method avoids the shortcomings of the deduction method described in section 4.3.1: resident taxpayers are treated equally from the perspective of the total domestic and foreign tax burden on their foreign source income, except when foreign taxes exceed domestic taxes. Moreover, subject to the same exception, the credit method is neutral with respect to a resident taxpayer's decision to invest domestically or abroad. These points are illustrated by the following example.

X and Y, who are both residents of Country A, each earn 100 of foreign source income. The foreign tax on such income is nil for X and 40 for Y. If both X and Y are subject to tax by Country A at a rate of 50 percent, X will pay 50 and Y will pay 10 of tax to Country A. In both cases, the combined domestic and foreign tax paid will be 50. If the foreign tax paid by Y is 60, however, the combined domestic and foreign tax rate on Y would be 60 percent because Country A would not provide relief for 10 of foreign taxes paid (60) in excess of domestic taxes (50) on the foreign source income. As a result, Y would pay tax of 60 and X would pay tax of 50.

Many countries allow foreign income taxes that cannot be credited in the current year (excess foreign tax credits) to be carried forward and credited against domestic taxes in future years. The carry forward period varies from country to country. The limitations on the credit apply to the deduction of these excess foreign tax credits in future years. Assume, for example, that R is resident in Country A, which imposes tax at a rate of 30 percent. In year 1, R earns foreign income of 100 and pays foreign tax of 50. The foreign tax is allowed as a credit against the Country A tax to the extent of 30, thereby eliminating completely the tax payable to Country A. To the extent that the foreign tax exceeds the Country A tax (20), the foreign tax is not creditable, and R has an excess credit of 20. In year 2, assume that R earns foreign income of 100 and pays

foreign tax of 25. R might be allowed a credit of 30 - the current foreign tax of 25 plus 5 of the excess credit carried forward from year 1 for use in future years. The amount of the excess credit from year 1 that is available for carry forward to year 3 and subsequent years would be reduced from 20 to 15.

On tax policy grounds, the credit method is recognized by many tax commentators to be theoretically the best method for eliminating international double taxation. The credit method, however, is not free from difficulties. Most importantly, the operation of a foreign tax credit system can be complex from the perspectives of both the government and taxpayers. Among the difficult questions that must be resolved are the following:

- What foreign taxes are creditable?
- How should the limitations on the credit be calculated? On a source-by-source, an item-by-item, a country-by-country, or an overall basis, with various special rules applicable to certain types of income? Or some combination of these methods?
- What rules should be adopted for determining the source of income and deductions?

Detailed, technical, and highly complicated legislative provisions are needed to resolve these and other matters if the credit method is to operate effectively. The compliance and administrative burdens imposed on taxpayers and tax authorities as a result of these complex rules are probably both necessary and justifiable in respect of income earned in no-tax or low-tax countries - otherwise, domestic tax could be avoided by diverting domestic source income to these countries.

When resident taxpayers are subject to foreign tax on their foreign source income at a rate that is comparable to the domestic tax rate, it is questionable whether the complexity of a credit system is worthwhile. In such circumstances, a country is unlikely to collect a significant amount of domestic tax from those taxpayers with respect to their foreign source income after allowing them a credit for foreign taxes. A foreign tax credit system used by one country may encourage other countries to increase their taxes on income earned by residents of that country to the level of tax in that country (so-called **"soak-up" taxes**). Such a tax increase would not affect the after-tax return to nonresident investors and therefore would not discourage investment from abroad. It would, however, result in a shift of tax revenues from the country with the credit system to the country in which the income is earned. For example, assume that Country A imposes tax at a rate of 40 percent and uses a foreign tax credit system, and that residents of Country A have substantial investments in Country B. If Country B imposes tax on the income earned by residents of Country A at 25 percent, the residents of Country A will be subject to tax by Country A on the income earned in Country B of 15 (40 - foreign tax credit of 25) and total taxes on the income of 40 (25 to Country B and 15 to Country A). However, if Country B imposes tax at 40 percent on the income earned by the residents of Country A, those residents will still be subject to total tax on the income of 40, but the entire tax will be paid to Country B.

A country is most likely to impose a discriminatory tax on residents of credit countries when the overwhelming amount of foreign investment in the country is owned by residents of a few foreign countries, and those foreign countries have approximately equivalent tax rates. Some countries include provisions in their foreign tax credit rules to prevent the soak-up taxes from qualifying as creditable foreign taxes.

Many countries use the credit method to eliminate international double taxation with respect to at least certain taxpayers and types of foreign source income. Some countries grant a credit for foreign taxes unilaterally; others grant a credit only pursuant to their bilateral tax treaties. Most credit countries grant the credit both unilaterally and by treaty. Still others have extended their foreign tax credit mechanisms to encompass "**tax sparing**". Tax sparing is discussed in section 4.5 below.

4.3.3.2 Types of Limitations

As noted above, countries that use the credit method limit the credit for foreign taxes to the amount of domestic tax on the foreign source income. For this purpose, countries use a variety of limitations.

Under an overall or worldwide limitation, foreign taxes paid to all foreign countries are aggregated; in effect, the credit is limited to the lesser of the aggregate of foreign taxes paid and the domestic tax payable on the total amount of the taxpayer's foreign source income. This method permits the averaging of high foreign taxes paid to some countries with low foreign taxes paid to other countries.

Under a country-by-country or per-country limitation, the credit is limited to the lesser of the taxes paid to a particular foreign country and the domestic tax payable on the taxpayer's income from that particular country. This method prevents the averaging of high and low foreign taxes paid to different countries, but it permits the averaging of high and low rates of foreign tax paid to a particular country on different types of income.

Under an item-by-item limitation, the credit is limited to the lesser of the foreign tax paid on each particular item of income and the domestic tax payable on that item of income. This method prevents averaging and is probably the best method from a theoretical perspective, although few countries use it in practice. In this context, an "item" of income is some defined category of income, such as interest income or shipping income. In principle, a country might define an item of income as any category of income subject to a special tax regime in a foreign country. For example, a country might treat business income and interest income arising in a foreign country as separate items of income for purposes of imposing a limitation on its foreign tax credit, especially if foreign countries tax interest income derived by nonresidents at preferential (low) rates.

The results of the overall, per-country, and item-by-item limitations on the foreign tax credit are compared in the following example. ACo, a resident of Country A, earns foreign source income and pays foreign taxes on such income, as shown in the following table.

Table 4.2 Example: Facts

	Foreign Income	*Foreign Tax*
Business income from Country X	100,000	45,000
Dividends from Country X	20,000	1,000
Business income from Country Y	50,000	10,000
Interest from Country Z	10,000	1,500

The corporate tax rate in Country A is 30 percent. ACo earns 200,000 domestic source income from its business carried on in Country A. If there is no limitation on the foreign tax credit, the amount of tax payable to Country A would be:

Example: No Limitation

Total income	380,000
Tax before credit (30%)	114,000
Foreign tax credit	57,500
Total tax	56,500

Therefore, the total tax payable would be 114,000 (foreign tax of 57,500 and Country A tax of 56,500). If Country A uses an overall, per-country, or item-by-item limitation, the tax payable would be as follows.

Table 4.3 Example: Overall Limitation

Overall Limitation	
Country A tax before credit	114,000
Credit:	
Lesser of:	
(1) Foreign tax of 57,500	
(2) Country A tax on foreign income (180,000 × 30% = 54,000)	54,000
Country A tax after credit	60,000
Total tax (57,500 + 60,000)	117,500

Example: Per-Country Limitation

Per-Country Limitation	
Country A tax before credit	114,000
Credit:	
(a) Country X	
Lesser of:	
(1) Foreign tax of 46,000	

(2) Country A tax on Country X income (120,000 × 30% = 36,000)	36,000
(b) Country Y	
Lesser of:	
(1) Foreign tax of 10,000	
(2) Country A tax on Country Y income (50,000 × 30% = 15,000)	10,000
(c) Country Z	
Lesser of:	
(1) Foreign tax of 1,500	
(2) Country A tax on Country Z income (10,000 × 30% = 3,000)	1,500
Total creditable taxes	47,500
Country A tax after credit	66,500
Total tax (66,500 + 57,500)	124,000

Example: Item-by-Item Limitation

Item-by-Item Limitation	
Country A tax before credit	114,000
Credit:	
(a) Country X	
(i) business income	
lesser of:	
(1) Foreign tax of 45,000	
(2) Country A tax on business income (100,000 × 30% = 30,000)	30,000
(ii) dividends	
lesser of:	
(1) Foreign tax of 1,000	
(2) Country A tax on dividends (20,000 × 30% = 6,000)	1,000
(b) Country Y	
lesser of:	
(1) Foreign tax of 10,000	
(2) Country A tax on business income (50,000 × 30% = 15,000)	10,000
(c) Country Z	
lesser of:	
(1) Foreign tax of 1,500	
(2) Country A tax on interest (10,000 × 30% = 3,000)	1,500
Total creditable taxes	42,500

Country A tax after credit	71,500
Total tax (71,500 + 57,500)	129,000

The three methods for limiting the foreign tax credit are not mutually exclusive. For example, a country could use an overall limitation as the basic method and also use the item-by-item method for certain types of income such as active business income and passive investment income. Several countries use this type of hybrid method, which is sometimes referred to as the **separate-baskets approach**.

4.3.3.3 Indirect or Underlying Credit

Some countries, such as the US, provide what is often referred to as an "indirect" or "underlying" foreign tax credit. The indirect credit is a credit granted to a resident corporation for the foreign income taxes paid by a foreign affiliated company when the resident corporation receives a dividend distribution from its foreign affiliate. The amount allowable as a credit is the amount of the underlying foreign tax paid by the foreign affiliate on the income out of which the dividend was paid. Ordinarily, a foreign tax credit is allowable only for foreign income taxes that a resident taxpayer pays directly. In effect, the indirect credit rules ignore the separate corporate existence of the resident and foreign corporations for the limited purpose of allowing the credit. To claim a credit for taxes paid by a foreign affiliate, the domestic corporation must usually own a substantial interest, varying from 5 percent to 25 percent, in the share capital of the foreign corporation.

The basic operation of an indirect foreign tax credit is illustrated in the following example. Assume that ACo, resident in Country A, has a wholly owned subsidiary BCo, resident in Country B. BCo's income for the year is 800, and it pays tax to Country B at a rate of 30 percent, or 240, on its income. BCo distributes all its after-tax profits of 560 (800 - 240) to ACo as a dividend. ACo is taxable in Country A on 800 - the dividend of 560 and the underlying tax of 240 (often referred to as the "gross-up amount"). Assuming that Country A levies tax at a rate of 40 percent and there is no limitation on the foreign tax credit, the tax payable to Country A would be 80 (320 minus a foreign tax credit of 240 for the foreign taxes paid by BCo on the income out of which the dividend was paid).

Table 4.4 Example: Indirect or Underlying Foreign Tax Credit

BCo's income	800
Country B tax	240
After-tax profit	560
Dividend paid	560
ACo's income:	
Dividend received from BCo	560
Gross-up amount	240

Total	800
Country A tax before credit (40%)	320
Credit for Country B tax paid by BCo	240
Net Country A tax	80

If the dividend received by ACo in the above example is subject to withholding tax by Country B, the withholding tax would also usually be creditable against ACo's tax payable to Country A, subject to any applicable limitation rule. The credit for withholding tax is a direct foreign tax credit, not an indirect credit, because ACo is treated as paying the withholding tax.

The credit method may have the effect of discouraging domestic corporations that have earned profits abroad through foreign affiliates from repatriating these profits as dividend distributions. Assume that ACo, resident in Country A, has a wholly owned affiliate, FCo, resident in Country F. The tax rate in Country A is 35 percent and the rate in Country F is 10 percent. FCo earns profits in Country F of 100 and pays tax to Country F of 10. If FCo's after-tax profits are repatriated to ACo as a dividend of 90, ACo will get a foreign tax credit of 10 for the underlying foreign tax paid by FCo, but it will be required to pay a net tax to Country A of 25, as shown below.

Table 4.5 Example: Effects of the Credit Method

Dividend received from ACo	90
Gross-up amount	10
Income of ACo	100
Country A tax before credit (35%)	35
Indirect foreign tax credit for taxes paid by FCo	10
Country A tax	25

By retaining the profits in FCo, ACo can defer indefinitely the potential Country A tax of 25. This type of tax planning strategy has been adopted by several US multinationals and has been sharply criticized by some US politicians.

To avoid creating a bias against the repatriation of profits, a credit country could tax the income of foreign affiliates of resident corporations on an accrual basis (i.e., as the income is earned by the foreign affiliates). Accrual taxation would eliminate the **deferral** of residence country tax on the foreign source income earned by residents through foreign affiliates. Proposals for a comprehensive accrual system have surfaced from time to time, but have not yet been adopted in any country, although accrual taxation is used in some circumstances. Under the **controlled foreign corporation rules** and the **foreign investment fund rules** described in sections 7.3 and 7.4, some countries impose domestic taxes currently on certain income earned by foreign affiliates and foreign funds in what are perceived to be abusive situations.

The rules designed to govern the indirect foreign tax credit are often the most complex part of a foreign tax credit system. The indirect credit is available only when a resident corporation receives a dividend from a foreign affiliate. The amount

allowable as a credit is the amount of foreign income tax properly attributable to the dividend. Difficult timing and income measurement issues must be resolved for this purpose. For example, the resident corporation must determine the profits of the foreign affiliate out of which the dividend was paid and the foreign tax attributable to those profits. Those profits may have been earned over many years in the past and would usually have been computed in a foreign currency under tax accounting rules that may differ significantly from the tax accounting rules applicable to the resident corporation. When these rules are combined with rules for limiting the foreign tax credit discussed in section 4.3.3.2 above, the level of complexity causes serious compliance and administrative problems. This complexity has led several countries to adopt exemption systems for dividends from foreign affiliates.

4.3.4 Comparison of the Exemption and Credit Methods

The debate about whether the exemption method or the credit method is better for relieving international double taxation is often vigorous and emotional. Few countries have either a pure exemption system or a pure credit system. Costa Rica, Hong Kong and Panama are examples of jurisdictions that tax on a territorial basis; they tax only income earned or having its source in their territory and generally exempt all foreign source income from tax. For most countries using the exemption method, however, the exemption of foreign source income is often restricted to certain active business income earned by resident corporations and dividends from foreign affiliates. Thus, a corporation is often exempt only on its active business income derived from foreign sources and dividends received out of the active business income of its foreign affiliates. An exemption is not generally available for investment income because such an exemption would make it easy for resident taxpayers to avoid paying taxes on their investment income by shifting the source of domestic investment income to a foreign country.

With respect to business income, an analysis of the exemption and credit methods indicates, first, that the two methods raise essentially the same structural issues, and second, that the two methods are reasonably comparable if designed properly. The following material compares an exemption for dividends received out of active business income of foreign affiliates and an indirect credit for the underlying foreign taxes paid by foreign affiliates on active business income.

The first point is that the results of these two methods for relieving international double taxation are the same if the underlying foreign taxes paid by the foreign affiliate, plus any withholding taxes on the dividends, are at least equal to the domestic taxes on the dividends. Under the exemption method, the dividends are exempt from domestic tax, so the total tax is the sum of the underlying foreign taxes paid by the foreign affiliate on the income out of which the dividend is paid and any foreign withholding taxes on the dividend. Under the indirect credit method, the underlying foreign taxes and the foreign withholding taxes are creditable against the domestic tax on the dividend. Therefore, if the sum of those foreign taxes equals or exceeds the domestic tax on the dividend, no domestic tax is payable. This result is illustrated in the following example.

Assume that Parentco, a company resident in Country A, has a wholly owned subsidiary, Forco, resident and carrying on business in Country B. Country A imposes tax on corporate profits at a rate of 35 percent. Country B imposes tax on corporate profits at a rate of 30 percent. Forco earns profits of 100, pays tax to Country B of 30, and distributes its entire after-tax income of 70 to Parentco as a dividend. The tax results, if Country A uses a participation exemption or an indirect credit system for relieving international double taxation of dividends, are shown in the table below.

Table 4.6 Comparison of Credit and Exemption Methods

	Credit	*Exemption*
Forco		
Income of foreign subsidiary	100	100
Foreign tax (30%)	30	30
Dividend to parent	70	70
Withholding tax (10%)	7	7
Parentco		
Dividend received	70	70
Gross-up amount	30	
Taxable income	100	0
Domestic tax before credit	35	-
Foreign tax credit	37	-
Net domestic tax	0	0
Total tax	37	37

Even if the sum of the foreign corporate tax and the dividend withholding tax is less than the domestic tax, remember that the domestic tax payable by Parentco is deferred until dividends are received. The longer the payment of dividends is deferred, the lower the present value of the domestic taxes on the dividends, assuming that the foreign affiliate can earn a higher after-tax rate of return on the funds than its parent corporation.

The usual justification for a participation exemption is simplicity: the reduction of the costs of administration and compliance for tax officials and taxpayers. However, the benefits of simplification are often overstated or are achieved only by sacrificing the integrity of the exemption.

If the participation exemption is intended to be a proxy for the indirect credit, it should be designed to ensure that the exemption is restricted to foreign source income that is subject to foreign tax rates that are comparable to domestic tax rates. A properly designed exemption system for dividends requires complicated rules to protect its integrity. Many of these rules are strikingly similar to the rules with respect to an indirect foreign tax credit. For example, both systems require rules dealing with:

- the resident taxpayers qualifying for the exemption or credit; (usually, the entitlement to the exemption or credit is limited to foreign affiliates in which

resident corporations have a substantial interest; (often defined as 10 percent or more of the share capital of the foreign affiliate))
- the type of income that qualifies for the exemption or indirect credit; (usually, these rules distinguish between active business income and other types of income)
- the source of income;
- allocation of expense rules; (see section 4.3.5 below)
- the current or accrual taxation of passive income of foreign corporations controlled by residents; (CFC rules, which are discussed in Chapter 7, section 7.3 below)
- the treatment of foreign losses; and
- the computation of the income of the foreign affiliate in accordance with domestic tax rules.

The most important difference between the exemption and indirect credit methods is that the indirect credit method requires a definition of creditable foreign taxes, whereas the exemption method requires rules to determine when foreign source income is subject to a level of foreign tax that is comparable to domestic tax (assuming that the exemption system is a proxy for an indirect credit system).

As noted above, many countries achieve the benefits of simplification with respect to their participation exemptions for dividends from foreign affiliates only by sacrificing the integrity of the exemption. In many participation exemptions, the exemption is available for dividends received from foreign affiliates that have not been subject to foreign tax rates comparable to domestic tax rates. Sometimes this appears to happen by inadvertence rather than intentionally. For example, a country may provide an exemption for dividends from foreign affiliates resident in countries with which it has entered into tax treaties. If the country enters into tax treaties with low-tax countries or countries that provide preferential low-tax regimes, the dividend exemption will be available for dividends from foreign affiliates in these countries, even though the income out of which the dividends are paid is not subject to foreign tax rates that are comparable to domestic tax rates.

Several countries have intentionally adopted participation exemption systems that do not even attempt to ensure that the income of the foreign affiliates is subject to foreign tax rates comparable to domestic tax rates. For these countries, the exemption method is not a proxy for the credit method. The underlying policy of such an exemption system is not just to eliminate international double taxation (although it accomplishes that result) but also to promote the international competitiveness of a country's resident multinational corporations. Thus, several countries have adopted exemption systems under which all dividends received by resident corporations from foreign affiliates in which they have a substantial interest are exempt from residence country tax. As a result, multinationals resident in such countries are able to compete in other countries with corporations resident in those countries and in third countries because they are subject to tax only by the country in which the business is carried on.

For example, assume that a multinational corporation, MCo, is resident in Country A, which imposes corporate tax at a rate of 35 percent. MCo has a wholly owned subsidiary that is resident and carries on business in Country B, which imposes corporate tax at a rate of 12.5 percent. If Country A taxes dividends received by MCo from its subsidiary in Country B, that tax represents a cost to MCo of carrying on business in Country B (although the cost is deferred until the dividends are paid) that corporations resident in Country B and resident in other countries that carry on business in Country B do not bear (assuming, of course, that those other countries exempt dividends from foreign affiliates from tax).

4.3.5 Treaty Aspects

As mentioned above, both the credit and exemption methods are authorized by Article 23 of the OECD and UN Model Treaties. The deduction method is not authorized by these model treaties. Article 23 of the OECD and UN Model Treaties establishes the general principles of exemption and credit, with each country left to establish detailed rules in its domestic law for the implementation of the general principle.

Some countries provide an exemption for foreign source income or a credit for foreign taxes paid (and paid by a foreign affiliate) under their domestic law in addition to providing relief in any treaties that they enter into. Treaty relief is still important, however, because it may be more generous than the unilateral relief provided in domestic law and because it constrains a country's ability to amend its domestic law to withdraw the double taxation relief afforded to its residents.

For example, assume that Country A provides an exemption in its domestic tax law for certain foreign source income earned by residents of Country A. Country A enters into a treaty with Country B that incorporates the same exemption. If Country A subsequently repeals the exemption in its domestic law, it must nevertheless continue to provide the exemption to its residents that earn income in Country B unless the treaty with Country B is modified or terminated.

4.4 ALLOCATION OF EXPENSES

Whether a country uses an exemption method or a credit method to provide relief from international double taxation, it should have rules for allocating a proper portion of the expenses incurred by its resident taxpayers between their foreign source gross income and their domestic source gross income. Most countries recognize the need for such rules for the purposes of taxing nonresidents on their domestic source income. Thus, expenses incurred by nonresidents will be denied unless those expenses are properly related to the earning of the domestic income subject to tax. Similar rules are necessary to properly apportion the expenses of resident taxpayers between domestic source and foreign source income for purposes of the foreign tax credit.

For countries that exempt foreign source income, expenses incurred by a resident taxpayer to earn that income should not be deductible. This result follows from the fundamental principle of tax law that expenses incurred to earn exempt income should

not be deductible. For example, a taxpayer should not be allowed to deduct interest expense on borrowed funds used to earn exempt foreign source income. A country that allows such interest expenses to be deductible provides its resident taxpayers with an incentive to earn exempt foreign source income rather than taxable domestic source income. In effect, the country is providing an exemption not only for foreign source income but also for a portion of the domestic source income of its resident taxpayers.

Most countries lack specific rules for attributing expenses to foreign source income. Two approaches that might be used for that purpose are tracing and allocation or apportionment. A tracing approach involves a factual inquiry into the connection between the expenses and the foreign source income. In contrast, allocation or apportionment involves the attribution of expenses to foreign source income by formula, either on the basis of the proportion of the taxpayer's foreign assets to its total assets or the proportion of its gross foreign income to its total gross income. Unlike tracing, allocation or apportionment is based on an assumption that the relevant expenses were incurred to support all of the taxpayer's assets or income-earning activities equally.

Countries that have a foreign tax credit system should allow resident taxpayers to deduct expenses incurred to earn foreign source income because those taxpayers are taxable on their worldwide income. As explained above, however, the foreign tax credit is invariably limited to the amount of a country's domestic tax otherwise imposed on foreign source taxable income. For this purpose, the amount of a taxpayer's foreign source taxable income must be computed properly or the limitation on the credit will be improperly inflated. In order to compute foreign source income properly, the taxpayer should be required to deduct from its gross foreign source income the expenses incurred to earn that income.

The need for expense allocation rules can be illustrated with a simple example. Assume that a resident corporation borrows 1,000 with interest at 8 percent annually and uses the loan proceeds to finance the business activities of a foreign branch. The foreign branch produces gross income of 280. After deducting the interest payment of 80, the branch's net income is 200. The net income of 200 is subject to foreign tax of 50 percent, resulting in a tax of 100. If the corporation's domestic source net income is 2,000, the corporation's total net income is 2,200. Assuming that the domestic tax rate is 40 percent, the tax payable, prior to subtracting the allowable foreign tax credit, is 880 (40 percent of 2,200). Subject to the limitation rules, the corporation is entitled to a credit for the foreign taxes paid. The credit is limited, however, to the lesser of 100 (the foreign tax paid) and 80 (880 × 200/2,200) (the domestic tax on the foreign source income).

Table 4.7 Allocation of Expenses

Gross foreign income	280
Interest expense	80
Net foreign income	200
Foreign tax (50%)	100

Net domestic income	2,000
Total income (200 + 2,000)	2,200
Domestic tax of 40%	880
Credit for foreign tax	80
Total tax	800

In the above example, the interest expense of 80 was applied or allocated totally against the foreign source income. If it had been applied against domestic source income, the entire amount of foreign taxes (100) would have been creditable against the domestic tax because the credit would be limited to the lesser of 100 and 112 (880 × 280/2,200). Assuming that the interest is properly attributable to the foreign source income, it should be allocated to that income in computing the limitation on the credit because otherwise the domestic tax system would be giving a credit for foreign taxes in excess of the domestic taxes on the foreign source net income. Therefore, in order to protect the domestic tax base, it is crucial for interest and other expenses to be allocated properly between domestic source and foreign source income.

An appropriate amount of expenses should also be attributed to foreign source income for purposes of computing the limitation on the indirect foreign tax credit, discussed in section 4.3.3.3. In addition, the indirect credit raises the issue of the timing of the deduction of expenses incurred by a resident parent corporation to earn foreign source income through a foreign affiliate. Residence country tax on foreign source income earned through a foreign affiliate is generally postponed or deferred until the resident parent receives a dividend (or other taxable distribution). Interest and other expenses incurred by the resident parent to earn that deferred income should not be deductible, at least theoretically, until the income to which the expenses relate is subject to residence country taxation. These payments should be deductible when the resident taxpayer receives a taxable distribution out of the related income from its foreign affiliate. Few countries currently attempt to deal with this timing issue because of its complexity.

4.5 TAX SPARING

Some tax treaties provide for "tax sparing", typically through a tax sparing credit. A tax sparing credit is a credit granted by the residence country for foreign taxes that, for some reason, were not actually paid to the source country but that would have been paid under the source country's normal tax rules. The usual reason for the tax not being paid is that the source country has provided a tax holiday or other tax incentive for foreign investors to invest or conduct business in the country. In the absence of tax sparing, the actual beneficiary of a tax incentive provided by a source country to attract foreign investment might be the country in which the investor is resident rather than the foreign investor. This result occurs whenever the reduction in source country tax is replaced by an increase in residence country tax.

The shifting of the benefit of an incentive from the foreign investor to its home country's treasury in the absence of tax sparing is illustrated by the following example. Country A, a developing country whose normal corporate tax rate is 30 percent, offers foreign corporations a ten-year tax holiday if they establish a manufacturing enterprise in Country A. BCo, a resident of Country B, establishes a manufacturing plant in Country A. Country B imposes corporate tax at a rate of 40 percent and uses a foreign tax credit system to provide relief from international double taxation. BCo earns income in Country A of 1,000 in the first year. In the absence of the tax holiday, Country A would impose a tax of 300 on BCo and Country B would impose a tax of 100 on BCo, determined by subtracting from the tax of 400 otherwise payable a foreign tax credit of 300. The tax holiday eliminates Country A's tax of 300. Therefore, BCo's tax liability to Country B becomes 400 minus the allowable credit, which is zero because BCo did not actually pay any tax to Country A due to the tax holiday. Thus, the tax revenue of 300 forgone by Country A in granting the tax holiday to BCo goes to the benefit of Country B and not to BCo.

If Country B were willing to give a tax sparing credit to BCo for the taxes forgone by Country A, then BCo would get the benefit of the tax holiday. Its income in Country A would be 1,000, and it would pay no tax to Country A. It would have an initial tax obligation of 400 in Country B but would be allowed to reduce that amount by the 300 of tax forgone by Country A, for a total tax liability of 100. The results are shown in the following table.

Table 4.8 Example: Tax Sparing

Country A	
Income from Country A	1,000
Country A tax before holiday	300
Tax holiday credit	300
Country A tax	0
Country B	
Income from Country B	1,000
Country B tax	400
Tax sparing credit	300
Total Country B tax	100

As the example shows, in the absence of the tax sparing credit, Country A's tax holiday will not have any impact on potential investors resident in Country B because their residence country tax will increase to offset the benefit of the tax incentive provided by Country A.

Tax sparing is primarily a feature of tax treaties between developed and developing countries. In the past, many developed countries granted some form of tax sparing to developing countries by way of treaty as a matter of course, with some voluntarily granting tax sparing in their treaties with developing countries as a way of encouraging investment in those countries, but others granting tax sparing credits only

reluctantly. Some developing countries traditionally have refused to enter into a tax treaty with a developed country unless they obtain a tax sparing credit.

The US is adamantly opposed to tax sparing and has not granted it in any of its tax treaties. Consequently, for many years it concluded very few tax treaties with developing countries. The US position is that the grant of a credit for phantom taxes - taxes not actually paid - is inconsistent with the efficiency and fairness goals of its foreign tax credit and encourages developing countries to engage in beggar-thy-neighbor bidding wars through their tax incentive programs. This position has been characterized as "arrogant", "imperialistic", and "patronizing", but it is a defensible assessment of the effects of tax sparing. In recent years, the hard-line view of many developing countries has softened, and the number of US tax treaties with developing countries is growing rapidly. Several other developed countries have recently agreed to tax sparing provisions in their treaties with developing countries only under stringent conditions.

The merits of tax sparing credits cannot be divorced from the merits of the tax incentives that they encourage. Although tax incentives have some enthusiastic supporters in the political arena, they are difficult to justify on the basis of tax policy principles. Certain targeted incentives aimed at achieving some identified goal may be justified, but those incentives are so narrowly drawn to prevent abuse that they tend to generate little political support. The general conclusion to be drawn from the voluminous tax literature dealing with tax incentives is that the costs of tax incentives are typically large, the benefits are always uncertain, and only rarely do the potential benefits justify the likely costs.

A developing country wishing to use tax incentives to attract foreign investment is not stymied by a failure to obtain a tax-sparing article in its tax treaties. Tax sparing obviously is not needed if the country of residence of the potential investors uses the exemption method to avoid double taxation - for investors resident in an exemption country, the source country tax is the only tax. Thus, any reduction in source taxation automatically accrues to their benefit. Even investors from credit countries may benefit from a source country incentive with a little tax planning, as the example below illustrates.

BCo, the investor resident in Country B in the preceding example, wants to obtain for itself the benefits of the tax holiday offered by Country A. To that end, it organizes ACo, a wholly owned subsidiary, in Country A. ACo engages in manufacturing activities that qualify for the tax holiday. ACo earns 1,000 from its manufacturing activities in Country A, which is not taxable by Country B because ACo is not resident in Country A and the income is not earned in Country A. BCo would be taxable by Country B on any dividends received from ACo, but ACo has no obligation to pay such dividends. Indeed, Country A may benefit more from its tax holiday under this arrangement than it would from tax sparing because the potential tax on dividends paid to BCo will provide a strong incentive for ACo to reinvest its profits in Country A. However, BCo may be reluctant to invest in Country A if it cannot repatriate any profits generated by its investment without paying tax.

The above example illustrates only one of several ways that tax incentives may benefit residents of countries using the credit method in the absence of tax sparing. Many US multinationals benefit from host country investment incentives because of

the way the US overall limitation on the foreign tax credit operates. Under this overall limitation, US corporations that pay high foreign taxes to one country can use what would otherwise be excess foreign tax credits to offset the US tax otherwise imposed on foreign business profits that are subject to low foreign taxes in another country. Assume, for example, that PCo, a US corporation, has an excess foreign tax credit of 35 from operations in Country A. PCo earns profits of 100 in Country B that ordinarily would be subject to tax in Country B of 35, but that tax is eliminated because of a tax holiday provided by Country B. PCo benefits from that tax holiday because it can eliminate the US tax of 35 that would otherwise be imposed on its profits in Country B with the excess credit of 35 from Country A.

Another problem with tax sparing is the potential for abusive tax avoidance. For example, generous tax sparing credits in a particular treaty often encourage residents of third countries to establish conduit entities in the country granting tax sparing. Tax sparing also puts pressure on the enforcement of a country's transfer pricing rules because taxpayers are encouraged to shift profits to the country providing the tax incentives.

In 1998 the OECD published a report, *Tax Sparing: A Reconsideration,* which suggests that the case for tax sparing is not persuasive. It recommends that tax sparing be restricted to countries whose economic development is at a considerably lower level than that of OECD member countries. It also sets out some best practices for the design of tax sparing provisions to ensure that the provisions are limited to genuine business investments and are not susceptible to abuse. See paragraphs 72-78.1 of the Commentary on Article 23 of the OECD Model Treaty.

CHAPTER 5

Taxation of Nonresidents

5.1 INTRODUCTION

As noted in Chapter 2, most countries tax their residents on their worldwide income and nonresidents on their domestic source income (i.e., income earned or derived in a country's territory). A few countries impose tax exclusively on domestic source income (territorial taxation) irrespective of whether the income is derived by a resident or a nonresident. Thus, it is fair to say that all countries, other than pure tax havens, tax the income earned or derived in their territory by nonresidents. For countries that tax on a worldwide basis, it is necessary to have rules that distinguish between residents and nonresidents because nonresidents are taxable only on their domestic source income, not on their worldwide income. The rules for determining whether a person is a resident of a country for income tax purposes are discussed in Chapter 2, section 2.2.

As discussed in Chapters 2 and 3, the international consensus is that countries are entitled to tax any income that arises or has its source in their territory. The rules for determining the source of income are dealt with in Chapter 2, section 2.3. A country's right to tax domestic source income takes priority over the right of another country to tax that income based on the residence of the person deriving the income. For this reason, the residence country has an obligation to relieve international double taxation in recognition of the source country's prior right to tax.

This chapter examines the major issues involved in taxing nonresidents on their domestic source income. The chapter begins with a brief discussion of the policy justification for taxing nonresidents and then deals with practical issues such as threshold requirements, the taxation of business profits and investment income of nonresidents, and the collection of tax from nonresidents.

It is convenient for conceptual purposes to divide the taxation of nonresidents into the following stages:

- A country must determine what type of connection (nexus) a nonresident must have to the country (activities in the country, the ownership of property

in the country, physical presence in the country, etc.) in order for the country to be able to exercise its jurisdiction to tax.
- Once a country has decided that it has jurisdiction to tax, it must decide whether it should exercise that jurisdiction to tax only if the nonresident meets some minimum threshold such as a permanent establishment or fixed base.
- If the threshold is met or the country decides that a threshold is unnecessary, a country must have rules to determine what amounts derived by nonresidents are subject to tax; these rules are usually referred to as source rules.
- Rules are necessary to compute the nonresident's income and tax payable.
- Finally, rules are necessary with respect to the collection of tax from nonresidents.

These stages are intimately connected and often overlap. For example, if a country decides to tax any interest or dividends paid by a resident to a nonresident, the source of the income as represented by the residence of the payer is the connection that gives the country the jurisdiction to tax; accordingly, that country has rejected the necessity for any threshold requirement. Similarly, transfer pricing rules can be viewed as source rules or as computational rules. These stages are set out here to assist in the analysis of the taxation of nonresidents; they do not attempt to describe the ways in which countries actually tax nonresidents.

The distinction between business profits and investment income is particularly important with respect to the taxation of nonresidents. Business income is typically taxed on a net basis at the same rates applicable to resident taxpayers, so that individuals earning business income in another country are often subject to tax at progressive rates. In contrast, investment income is typically taxed at a flat rate on the gross amount; moreover, the tax is usually imposed by way of a withholding tax (i.e., there is an obligation on the resident person paying the amount to the nonresident to withhold the amount of the tax from the payment to the nonresident and to remit the tax to the tax authorities).

5.2 TAX POLICY CONSIDERATIONS IN TAXING NONRESIDENTS

It may be recalled from Chapter 3, section 3.2 that the tax policy justifications for taxing residents on their worldwide income are equity and neutrality. It is difficult to justify taxing nonresidents on the basis of equity because the source country does not have complete information about the nonresident's tax situation; for example, income earned in the source country may be offset by losses incurred in other countries. It is generally impossible for a country to determine whether residents and nonresidents are similarly situated for tax purposes except in situations where all or almost all of a nonresident's income is derived from one country.

In general, however, it is reasonable to say that, to the extent possible, nonresidents should not be treated better or worse than residents in similar situations. The

taxation of nonresidents on their domestic source income can be justified on the basis that nonresidents derive benefits from the source country; for example, nonresidents doing business in a country take advantage of the country's infrastructure and its legal system in the same way as residents. It can also be argued that, even if a nonresident simply sells goods in a country, the nonresident is benefiting from the market provided by that country and that benefit is sufficient to justify taxation.

The principle that nonresidents deriving income from a country should not be treated less favorably than residents of that country - the **nondiscrimination principle** - is an important principle that most countries follow, at least in part. Although it may be tempting for a country to tax nonresidents more harshly than residents - after all, nonresidents do not vote - the likely response of other countries would be to do the same, thus putting the first country's residents at a disadvantage. In practice, there is surprisingly little discrimination against nonresidents in the tax systems of most countries. Many countries do, however, discriminate in favor of nonresidents in certain circumstances by providing them with tax holidays and other tax incentives in order to attract foreign investment. Discrimination in favor of nonresidents is not considered to be offensive, although it is widely criticized by tax policy commentators. The nondiscrimination principle is recognized in Article 24 of both the OECD and the UN Model Treaties. The **nondiscrimination article** in tax treaties is dealt with in Chapter 8, section 8.8.1.

From a revenue perspective, it makes obvious sense for countries to tax nonresidents. However, the need for tax revenue must be balanced against the need for foreign investment. If a country taxes nonresidents too harshly, the effect may be to discourage nonresidents from investing in the country; moreover, other countries can be expected to respond by taxing that country's residents equally harshly. Thus, countries that import and export capital and tax on a worldwide basis have interests as both residence countries and source countries that must be balanced. As residence countries, they want to minimize tax imposed by source countries on the foreign source income of their residents and to ensure that their residents are not discriminated against relative to the residents of source countries. As source countries, they want to attract foreign investment but also want to tax nonresidents as heavily as possible. These competing interests cannot all be achieved fully because of the inevitable retaliation by other countries that would result.

Another important consideration in the taxation of nonresidents is enforcement. On the one hand, it obviously makes no sense for a country to impose tax on nonresidents that cannot be enforced effectively. On the other hand, it may not make sense for a country to tax all the income derived by nonresidents that can be enforced effectively. Most countries do not follow the practice of taxing nonresidents on everything that they can tax, probably because, as noted above, they do not want other countries to do the same and they want to attract foreign investment. Nevertheless, it is probably fair to say that countries seriously consider taxing nonresidents to the maximum extent possible unless there is some good reason not to.

5.3 THRESHOLD REQUIREMENTS

Although there is no restriction on the authority of a country to tax any and all domestic source income derived by a nonresident, few countries do so – most countries tax nonresidents on certain types of income only if a minimum threshold is met. For example, many countries tax nonresidents on their business income only if the income is attributable to a PE in the country. This threshold for the taxation of business profits is also used in Article 7 of the OECD and UN Model Treaties. Even countries that do not use the PE concept in their domestic law usually tax nonresidents on their business income only if their business activities exceed some threshold; for example, in the United States nonresidents are taxable on their business income only if they are engaged in a trade or business in the United States.

There are several reasons for the establishment of a threshold requirement for the taxation of nonresidents. First, serious compliance and enforcement problems arise when nonresidents are taxable on all domestic source income. It is difficult for tax authorities to identify all nonresidents earning income from the country and to get information about that income. (Consider, for example, the difficulties in taxing a consultant who performs services in a country for a few days.) Moreover, unless a nonresident has some type of substantial and continuing presence in a country, it may be difficult or impossible for the country to collect its tax. Second, as noted in Chapter 2, section 2.3, few countries have detailed source rules; as a result, a threshold requirement can provide more certainty for nonresidents as to when they become subject to tax by a country. Third, requiring nonresidents to file tax returns and pay tax on relatively small amounts of income is likely to discourage cross-border trade and investment or result in nonresidents ignoring their tax obligations.

Threshold requirements for taxing nonresidents are provided by domestic law and tax treaties and differ depending on the type of income. Some common thresholds are described below:

- *Business profits*: The threshold provided by tax treaties is the existence of a PE in a country. In general, a PE is a fixed place of business or a dependent agent with authority to contract on behalf of the nonresident. Certain types of business profits, such as income derived by entertainers and athletes, are usually subject to a lower threshold. The UN Model Treaty uses a 183-day threshold for the taxation of income from services derived by nonresidents and has a special provision for insurance businesses.
- *Income from immovable property:* The immovable property must be located in the country.
- *Employment income:* As a general rule, the threshold is the physical presence of the employee in the country and the performance of the duties of employment in the country, although under tax treaties the source country is precluded from taxing a nonresident employee of a nonresident employer without a PE in the source country, unless the employee is physically present for more than 183 days.

- *Investment income:* Typically, there is no threshold for source country taxation of dividends, interest, and royalties under domestic law or treaties. As discussed below, the source country tax is imposed as a final withholding tax at a flat rate on the gross amount of the payment.

In general, thresholds for the taxation of nonresidents take the form of a fixed place (either a fixed place of business or immovable property) or the physical presence of the nonresident in the country (sometimes for a specified period). Thresholds based on the amount of revenue or income derived by a nonresident are rare in both domestic law and treaties.

5.4 SOURCE RULES

Once it has been determined that a country has jurisdiction to tax a nonresident and that any threshold for taxation has been met, it is necessary to have rules to determine what amounts are subject to tax and how those amounts are taxed. In general, countries tax nonresidents only on their domestic source income. As a result, source-of-income rules are necessary to determine whether a nonresident's income is derived from sources inside the territory of the country. Sometimes these source rules are explicit: for example, a country's tax law might provide that a nonresident is taxable on domestic source income and then list items or amounts that are considered to be from domestic sources. More often, however, countries simply prescribe the amounts derived by nonresidents that are subject to tax, without explicit reference to the source of those amounts. For example, a country might impose tax on dividends paid by a resident corporation to a nonresident. The source rule in this case is implicit - in effect, dividends are considered to have their source in the country in which the company paying the dividends is resident. Except in cases where the income is taxed on a gross basis, it is also necessary to determine what expenses are deductible in determining the domestic income subject to tax. Source rules are discussed in more detail in Chapter 2, section 2.3.

5.5 DOUBLE TAXATION

In situations where a resident of one country earns income sourced in another country, by international consensus the country in which the income is earned has the first right to tax the income, and the residence country has a corresponding obligation to relieve international double taxation by exempting the income from tax or providing a credit for the source country tax. Therefore, in taxing nonresidents, countries do not need to be concerned about eliminating double taxation of this type. The only type of double taxation that source countries should be concerned about is where two countries both claim that the relevant item of income has its source in their country. Accordingly, the more expansive a country's source rules are, the more likely it is that its source claims will overlap with other countries' source claims.

5.6 EXCESSIVE TAXATION OF NONRESIDENTS

Although source countries do not need to be concerned about the elimination of double taxation except in the case of overlapping source rules, they should be concerned about the excessive taxation of nonresidents. As discussed below, certain types of income are typically taxed by withholding at a flat rate on the gross amount of the payment. In these situations, there is a risk that the source country tax may be excessive relative to the net income derived by the nonresident. For example, consider a situation in which a nonresident incurs substantial expenses to earn royalties in a country. If the source country taxes the royalties at a flat rate of 30 percent without any recognition for the expenses, the nonresident may realize little, if any, after-tax profit from the transaction. If the residence country exempts foreign source royalties, it will not provide any relief for the source country tax; and even if the residence country provides a foreign tax credit, the limitation on the credit (see Chapter 4, section 4.3.3 for a discussion of the limitations on a foreign tax credit) will likely result in the taxpayer getting only partial relief for the source country tax. The overall result is that the royalties may be taxable at an effective rate that is considerably higher than the residence country tax rate. Sometimes nonresidents may be able to avoid excessive source country taxation by requiring the resident payers to effectively absorb the tax by grossing up the payments. Such excessive source country tax may be borne by residents or may discourage foreign investment.

5.7 COMPUTATION OF THE DOMESTIC SOURCE INCOME OF NONRESIDENTS

In general, the rules for computing the income of nonresidents are the same as the rules applicable to residents. Thus, the rules that determine what amounts are included in income, what deductions are allowable, and the timing of income and deductions are applicable equally to residents and nonresidents. For example, if a country allows a deduction for only a portion of a taxpayer's entertainment expenses, that rule will apply equally to nonresidents. Although in general the rules for computing the income of residents and nonresidents are the same, there are some exceptions. For example, transfer pricing rules apply to transactions between a resident and a related nonresident and not to transactions between related residents. Transfer pricing rules are discussed in Chapter 6. Similarly, thin capitalization rules are typically applicable only to interest paid by a resident corporation to nonresidents, although in a few countries the rules also apply to interest paid to tax-exempt residents. Conversely, controlled foreign corporation (CFC) rules apply only to nonresident companies that are controlled by residents of a country. Thin capitalization rules and CFC rules are dealt with in detail in Chapter 7, sections 7.2 and 7.3 respectively. It should be noted in this regard that the case law of the European Court of Justice has severely restricted the ability of an EU member country to have rules, such as thin capitalization rules or CFC rules, that apply differently to residents of that country and residents of another EU member country.

As discussed below in section 5.8, the nondiscrimination article of an applicable tax treaty requires the source country to allow nonresidents to deduct expenses in computing the profits attributable to a PE on the same basis as residents engaged in similar activities. However, where nonresidents are subject to tax on a gross withholding tax basis, no deductions are allowed. Therefore, the distinction between amounts such as business profits, which are subject to net-based taxation, and amounts such as investment income, which are subject to withholding tax, is very important. This distinction is discussed in section 5.8.1 below.

With respect to nonresident individuals, personal deductions, reliefs, allowances and credits are not customarily provided by source countries. For example, many countries provide a basic personal or family exemption from tax so that if an individual's or family's income does not exceed the minimum amount, no tax is payable. Similarly, many countries provide deductions or allowances for family members who are dependent on the taxpayer for support. These and other similar personal allowances are not generally provided by countries to nonresidents, and the typical nondiscrimination article in tax treaties does not require such allowances to be extended to nonresidents.

As mentioned above, there are no legal constraints to prevent a source country from treating nonresidents more favorably than residents. In particular, many developing countries provide nonresident investors with special tax incentives that are not available to residents.

If a country imposes a final withholding tax on the gross amount of certain payments, such as dividends, interest, and royalties, no computational rules are necessary since the gross amount is taxable. If, however, the withholding tax is imposed on an interim basis on account of a nonresident's final tax liability, rules for the computation of net income are necessary. Some South American countries impose final withholding taxes on a wide range of payments made to nonresidents. In many cases, the tax is imposed at a fixed rate on a fixed percentage of the payment rather than on the gross amount. Taxing a presumptive amount in this way represents an attempt to give relief for the expenses incurred to earn certain types of income without the necessity for either the taxpayer or the tax authorities to calculate a particular nonresident's actual income.

5.8 TAXATION OF VARIOUS TYPES OF INCOME OF NONRESIDENTS

5.8.1 Business Income

5.8.1.1 In General

Because business income earned by nonresidents is usually taxed on a net basis and investment income is taxed on a gross basis, it is important to distinguish between the two types of income. In some civil law countries, all the income earned by a legal entity is characterized as business income, and therefore it is necessary to distinguish

between business and other income only with respect to individuals. In other countries, however, both legal entities and individuals can earn various types of income. Some countries tax on a schedular basis, which means that they tax different types of income in accordance with different rules, and sometimes even at different rates. Even countries that tax on a global basis often have different rules for business income and other income. Typically, the characterization of an amount as income from business or other income arises with respect to capital gains from the disposal of property, interest, rent, and royalties.

How is the distinction between business and other income made? In many Commonwealth countries, there is a substantial body of case law concerning the distinction between capital gains and ordinary business income. This case law is usually equally applicable to nonresidents. Countries may also have statutory rules that distinguish between the two types of income. For example, some countries have rules that limit capital gains treatment to property that is held or owned for a minimum period; other gains are treated as ordinary business income. More generally, some countries may have rules that define business income.

The distinction between business and other types of income is also important for purposes of tax treaties because tax treaties deal with various types of income on a schedular basis. As a result, for example, business income, interest and capital gains are subject to different rules. The OECD and UN Model Treaties, on which most bilateral tax treaties are based, do not provide a comprehensive definition of "business". Since 2000, the OECD Model Treaty has defined business to include the performance of independent and professional services (Article 3(1)(f)) because Article 14 dealing with such activities was deleted at that time. Because of the absence of a complete definition in the treaty, it is necessary to refer to the meaning of the term "business" under the domestic law of the country applying the treaty.

Under tax treaties based on the OECD and UN Model Treaties, it is also necessary to distinguish between various types of business income. In general, under Article 7, business income derived by a resident of one country in the other country is taxable by the other country only if the business is carried on through a PE and the income is attributable to the PE. Under Article 8, however, income from international shipping and air transportation income is taxable only by the country in which the enterprise has its place of effective management. In contrast, under Article 17, business income from personal services performed by a resident of one country in the other country as an entertainer or athlete is taxable by that other country without the need for a PE in the country. In effect, under tax treaties, a PE is a threshold requirement for most business income; the rule that only profits attributable to the PE are taxable is the functional equivalent of a source rule. In the interests of accuracy, it must be noted that under Article 7, the profits attributable to a PE can include profits from outside the country in which the PE is located. These treaty rules are discussed further in Chapter 8, section 8.8.5.

Business income derived by a nonresident is usually taxed by the country in which the income is earned on a net basis, and the rules for the computation of

business income are generally the same as the rules for residents. The nondiscrimination article of tax treaties (Article 24(3) of the OECD and UN Model Treaties) requires the source country to tax a PE of a resident of the other state no less favorably than a resident of the source country carrying on the same activities. The nondiscrimination article is discussed in more detail in Chapter 8, section 8.8.1. Once a nonresident has met the minimum threshold requirement for taxation in the source country (usually the existence of a PE in the source country), domestic tax rules will apply in order to determine the amount of income from the business that is subject to tax. In some countries, once a nonresident has a PE in the source country all the nonresident's income from the source country becomes taxable. However, most countries do not follow this **force-of-attraction principle**. Instead, only the income from the business carried on in the source country is taxable (although other amounts, such as investment income, may be taxable on a different basis). Under the OECD Model Treaty, there is no force of attraction; only income that is attributable to the PE is taxable by the source country. Under the UN Model Treaty, there is a limited force-of-attraction rule: the source country is authorized to tax any business profits from the source country of the same or similar kind as those derived through the PE. The treaty rules for the attribution of profits to a PE are discussed in Chapter 8, section 8.5.

5.8.1.2 Branch Taxes

As noted several times in this Primer, taxpayers generally have the choice of doing business in a country in the form of a branch or a separate legal entity, usually a company. For corporate taxpayers, this choice is usually described as a choice between a branch and a subsidiary. If a corporation resident in one country forms a subsidiary corporation in another country, the subsidiary will likely be treated as a separate legal and taxable entity, and therefore as a resident of the other country (assuming that the subsidiary's place of management is located in that country). If a corporation establishes a branch in another country, the branch is simply a part of the corporation. As a resident of the source country, a subsidiary of a nonresident corporation is ordinarily taxable on its worldwide income, whereas in respect of a branch only the domestic source income attributable to the branch is usually taxable by the source country. If, however, the subsidiary earns exclusively domestic source income (i.e., all of its income is earned in the country in which it is resident), there is no difference between the subsidiary and a branch in this regard.

There is a significant difference with respect to the tax consequences of the repatriation of funds from a branch or subsidiary. If a subsidiary pays a dividend to its nonresident parent, the country in which the subsidiary is resident may impose a withholding tax on the gross amount of the dividend. In contrast, if funds are withdrawn from a branch and repatriated to the head office of the nonresident corporation, there is no dividend or other payment on which the source country can levy tax. Therefore, nonresidents may prefer to do business in a country through a branch rather than a subsidiary in order to avoid withholding taxes on dividends and other intercorporate payments. Some countries (e.g., Canada and the United States),

have adopted special branch taxes in order to equalize the treatment of branches and subsidiaries. These branch taxes can be quite complicated because of the need to impose a tax that is equivalent to a withholding tax on dividends on the basis of some type of proxy for dividends. Other countries impose a slightly higher rate of tax on nonresidents carrying on business in the form of a branch in order to make up for the lack of withholding tax on the repatriation of funds from branches. Both of these measures appear to violate the nondiscrimination article of a typical tax treaty, although they are arguably justifiable on tax policy grounds.

If borrowed funds are used to finance the activities of a branch, the interest expense incurred with respect to the funds is ordinarily deductible in computing the profits of the branch under both domestic law and tax treaties. Such interest expense erodes the tax base of the country in which the branch is located; however, the interest is not usually subject to withholding tax because the interest is paid by a nonresident. A few countries attempt to subject such interest to withholding tax.

5.8.2 Income from Immovable Property

The ownership or use by a nonresident of immovable property situated in a country is clearly sufficient to justify jurisdiction to tax by that country. In addition, the existence of the immovable property operates as a threshold requirement and as a source rule. The country in which immovable property is situated is entitled to tax the nonresident owner on any income derived from the property or any capital gains derived from the disposal of the property. Articles 6 and 13(1) of the OECD and Model Treaties confirm the source country's right to tax income and gains from immovable property on this basis.

Income from immovable property is treated differently from income from business under the OECD and UN Model Treaties. Although the location of immovable property in a country may be seen as the equivalent of a PE in terms of nexus, under Article 6 there is no requirement for income from immovable property to be taxed on a net basis, as there is for business profits under Article 7. In any cases of conflict between Articles 6 and 7, Article 6 clearly prevails (see Article 6(4) and Article 7(4) of the OECD Model Treaty and Article 6(4) and Article 7(6) of the UN Model Treaty). As a result, there is nothing in a typical tax treaty to prevent a country from taxing income from immovable property on a gross basis, and, in fact, some countries tax some types of income from immovable property on a presumptive basis. It is important, therefore, to understand how a country defines and taxes income from immovable property under its domestic law.

5.8.3 Income from Employment

A country has jurisdiction to tax nonresident employees if the employment activities are performed in the country or the income is derived from the country, or even if the

benefits from the employment activities are used or consumed in the country. In most countries, there is no minimum threshold for the taxation of nonresident employees, although the United States provides an exemption for nonresident employees who are paid by a nonresident employer, earn not more than USD 3,000, and are present in the United States for not more than ninety days. If a nonresident is employed by a resident employer, any tax on the employee is relatively easy to enforce by requiring the employer to withhold the tax. Even if the employer is a nonresident, the tax can be effectively enforced if the employer has a PE in the source country. In other situations, any tax imposed on a nonresident employee who spends a few days in a country performing services may be difficult to enforce.

Under the OECD and UN Model Treaties, income from employment derived by a nonresident employee is taxable by the source country only if the employee is present in the country to perform the employment services. An exemption is provided for nonresident employees if they are present in the source country for less than 183 days, they are not paid by a resident employer, and their remuneration is not deductible for purposes of computing the income of a PE that the nonresident employer has in the source country.

5.8.4 Investment Income: Dividends, Interest, and Royalties

Most countries tax certain investment income derived by nonresidents. For this purpose, it is necessary to define the types of investment income that are taxable and, in particular, to distinguish between business income and investment income, as discussed in section 5.8.1.1. This distinction cannot be made solely on the basis of the nature of the income because, for example, interest earned by a financial institution from lending money is clearly income from business, whereas interest earned by an individual investor is investment income.

The distinction is important because, typically, investment income is taxable by source countries through a withholding tax at a flat rate on the gross amount paid to nonresidents, while business income is usually taxable on a net basis by way of an assessment. It may be questioned whether a gross basis withholding tax is appropriate as part of an income tax; however, in practice, the difficulty of enforcing tax imposed on the investment income of nonresidents makes withholding taxes generally acceptable if the rate is limited so that the withholding tax approximates the tax that would be imposed at ordinary rates on net income. This explains why withholding tax is generally limited to amounts in respect of which the nonresident is unlikely to have incurred substantial expenses to earn those amounts.

The imposition of tax on the gross amount of interest, rent, or royalties can be excessive in certain circumstances, as explained in section 5.6 above.

Investment income derived by nonresidents is typically taxed without any threshold requirement under either domestic law or tax treaties; in general, it is considered to have its source in the country in which the payer is resident. The same source rule is used in Article 10 through 12 of the OECD and UN Model Treaties. Several countries, however, have special source rules for certain types of investment income.

For example, interest and royalties may be considered to be earned where the funds or property are used.

5.8.5 Capital Gains

The taxation of capital gains realized by nonresidents presents special problems for countries that tax such gains differently from business income. Many countries tax capital gains derived by nonresidents from the disposal of immovable property situated in their countries, property of a business carried on (often through a PE) in their countries, and substantial participations in resident companies, partnerships, and other legal entities. Most countries do not tax nonresidents on capital gains from the disposal of shares of resident companies other than land-rich companies (companies whose assets consist primarily of immovable property located in the country) and substantial participations. This pattern is reflected in Article 13 of the OECD and UN Model Treaties, except that, under the OECD Model Treaty, source countries are not allowed to tax capital gains from substantial participations.

The enforcement of tax on the capital gains of nonresidents raises special difficulties. If a nonresident sells immovable property situated in a country, that country's tax on the capital gain can be enforced by requiring the purchaser to withhold an amount on account of the seller's tax from the purchase price, unless the nonresident prepays the tax or provides security for the payment of the tax, such as a bank guarantee. If the prepayment is excessive, the nonresident is usually entitled to file a return to claim a refund of the excess. Even if the nonresident sells the property to another nonresident, the tax can usually be enforced in this way by refusing to allow the purchaser to register the property unless the tax has been paid.

In the case of the sale of the property of a business carried on in a country by a nonresident, the tax on any capital gains from the disposal of the business assets can be enforced in the same way as tax on the income from the business, although the tax may be difficult to collect where the nonresident sells all the assets of the business.

The taxation of capital gains in respect of shares of resident companies holding immovable property is necessary to prevent the easy avoidance of the tax on gains from the disposal of immovable property by holding the property in a resident company and then selling the shares of the company rather than the immovable property itself. The rule in Article 13(4) of the OECD and UN Model Treaties provides that a country is entitled to tax gains from the sale of shares of a resident company if more than 50 percent of the value of the shares of the company is attributable, directly or indirectly, to immovable property situated in the country. For capital gains from the sale of shares of land-rich resident companies, or substantial participations in resident companies, the only effective method of enforcing the tax is to place an obligation on the purchaser to withhold the tax from the purchase price. This method of enforcement is not as effective for shares as for the disposal of immovable property because in the case of immovable property, the tax can be registered as a lien against the property, whereas in the case of shares, the immovable property is owned by the company.

5.9 ADMINISTRATIVE ASPECTS OF TAXING NONRESIDENTS

5.9.1 Introduction

The difficulties of tax administration are exacerbated with respect to the taxation of cross-border transactions and investment involving both residents and nonresidents. Collecting tax from nonresidents earning domestic source income is different from collecting tax from residents because, unlike nonresidents, residents are usually present in a country (or have substantial connections with the country) and are subject to its legal system. It makes little sense for a country to impose a tax on nonresidents that it cannot collect. In this section, two major problems are examined: obtaining the necessary information and collecting the tax.

5.9.2 Obtaining Information about Domestic Source Income of Nonresidents

The basic question here is: what information do source countries need to collect tax effectively from nonresidents? First, they need basic information, such as name, address, and taxpayer identification number if available, to identify nonresidents earning domestic source income. Second, they need information to determine whether nonresidents are carrying on business in their countries, or have PEs there, or are earning investment income there. Third, information is necessary to determine or verify the computation of a nonresident's domestic source income (revenue and expenses). Fourth, information is necessary concerning transactions with related persons, especially with related persons who are residents of the source country. Fifth, if the nonresident is claiming a reduction of or exemption from source country tax under an applicable tax treaty, the source country should have sufficient information to verify whether the benefits of the treaty should be granted.

In some cases, the necessary information can be obtained by imposing reporting requirements on the nonresidents themselves. Ideally, however, the tax authorities should have independent information to verify information provided by nonresidents.

In other cases, information can be obtained from residents who have relationships or transactions with nonresidents. For example, residents paying dividends, interest, royalties or other amounts to nonresidents can be required to report basic information about the nonresident recipients and the amount and nature of the payments. Imposing these types of reporting requirements on third persons may result in their incurring significant compliance costs. As a result, in adopting such reporting requirements, a source country must carefully balance the need for information against the compliance costs imposed on third parties. A country should not ask for information that it cannot use effectively.

Information should be provided in electronic format if the tax authorities have the necessary technology to use information in this format. If the tax authorities have information in electronic format and have taxpayer identification numbers, they will be able to match information from various sources. The information should be provided in a consistent format from year to year. It can be filed with the nonresident's tax return

(assuming that a return is required) or filed separately, or retained by the taxpayer for possible inspection by the tax authorities.

In many situations, the necessary information is located outside the source country. If the information is in the possession of the taxpayer, a penalty can be imposed on the taxpayer for failing to produce the information on a timely basis. Some countries have adopted special rules to preclude a taxpayer from introducing in any subsequent legal proceedings foreign-based information that is not disclosed to the tax authorities when requested; such a rule is ineffective if the taxpayer discloses all of the information favorable to the taxpayer's case. If the information is in the possession of an unrelated third party, the taxpayer should not be penalized for not producing the information. If the information is held by a related party, however, it may be appropriate to impose penalties in certain circumstances.

If there is a treaty in place between the source country and the country in which the nonresident is resident, foreign-based information may be obtained through the exchange-of-information provision in the treaty. Bilateral tax treaties based on the OECD or UN Model Treaties contain an exchange-of-information article (Article 26), which authorizes the tax authorities to exchange many types of information in response to a specific request from the other country, and to do so automatically. In addition, several countries have recently entered into Tax Information Exchange Agreements (TIEAs) with countries (such as tax havens) with which they do not have comprehensive tax treaties. Comprehensive tax treaties with these countries are not necessary, but exchange of information can be useful for both residence and source countries. Exchange of information is also covered by multilateral agreements among the Nordic countries, the European Union, and a joint Convention on Mutual Administrative Assistance in Tax Matters of the Council of Europe and the OECD, which entered into force in 1995; after a slow start, over ninety countries have now been signed this Convention. Exchange of information under tax treaties is discussed in more detail in Chapter 8, section 8.8.4.

5.9.3 Collection of Tax from Nonresidents

There are two basic ways of determining the tax payable by nonresidents: assessment and withholding. Assessment is typically used in situations in which nonresidents are taxed on a net basis, whereas withholding is typically used for passive investment income. Assessment involves the determination of a nonresident's income subject to tax and tax payable, usually by way of the filing of a tax return. If the nonresident does not pay any tax owing, the source country can take action to enforce the tax in accordance with its domestic law.

Withholding operates by the imposition of an obligation on persons (usually residents) paying certain amounts to nonresidents to withhold tax at a specified percentage from those payments and remit the tax to the tax authorities on behalf of the nonresident. There are two types of withholding. Provisional or interim withholding is purely a collection device. The amounts withheld are remitted to the tax authorities on account of the nonresident taxpayer; they are treated, in effect, like installments of tax

paid by the nonresident. The nonresident is under an obligation to file a return and either pay any tax owing in excess of the amount withheld or receive a refund of the amount withheld in excess of the tax payable. If the nonresident does not file a return, the tax authorities have access to the amounts withheld to satisfy the nonresident's tax liability.

Provisional withholding by employers is often used to collect tax from salary and wages paid to employees. Final withholding is a tax imposed on the gross amount (or a percentage of that amount) of the payment to a nonresident. It is final because the nonresident is not entitled to file a return on the basis of its actual net income. Although a final withholding tax is not, in form, an income tax, if the rate of withholding tax is set appropriately, it is recognized as an internationally accepted proxy for an income tax because of the difficulties in collecting tax from nonresidents.

Obviously, if a nonresident has assets in the source country or is physically present in the source country, collection action can be taken by the source country directly against the nonresident. In these circumstances, which may include nonresidents carrying on business in a country, source countries typically impose tax by means of an assessment levied on the nonresident. In countries with self-assessment systems, nonresidents are expected to file tax returns in which they report their revenue and expenses and determine their tax payable. Source countries can audit nonresidents' tax returns and enforce tax payable by nonresidents in largely the same way as with residents. Often such nonresidents may be required to pay periodic installments of tax throughout a taxation year; they may also be subject to interim or provisional withholding on certain amounts paid to them and by them.

If, however, the nonresident is not present and does not have significant assets in the source country, the source country must take special measures to collect its tax. First, the source country might consider obtaining a court judgment for the unpaid tax against the nonresident from the country's courts and then seeking enforcement of that judgment by the courts in the nonresident's country of residence. The problem with this course of action is that many countries will not enforce other countries' criminal and tax judgments (this is widely known as the revenue rule). Second, the source country may consider requesting assistance in the collection of the unpaid tax from the country of residence pursuant to the tax treaty between the two countries, if that treaty has an article dealing with Assistance in Collection based on Article 27 of the OECD and UN Model Treaties. However, Article 27 was added to the OECD Model only in 2002 and to the UN Model in 2011, and has been included in relatively few treaties to date. Third, if the source and residence countries are parties to a multilateral convention dealing with administrative assistance in tax matters, such as the Convention on Mutual Administrative Assistance in Tax Matters, referred to above in section 5.9.2 in connection with exchange of information, the source country can request the residence country to collect the source country's tax as if it were tax owing to the residence country.

Many countries have concluded that withholding is the most effective method of collecting tax from nonresidents that do not have a significant presence in the country. The withholding is usually provisional with respect to amounts such as employment income, other income from services, and sometimes rents and royalties, because the

net income may be significantly less than the gross amount. Nonresidents have the right to file a return and obtain a refund of any excess tax withheld. Often, however, as a practical matter, provisional withholding operates as a final withholding tax because the nonresident may choose not to file a return unless the amount withheld is substantially in excess of the amount of tax payable. Also, unfortunately, some countries may make it difficult, either deliberately or inadvertently through inefficient tax administration, for nonresidents to obtain refunds.

A final withholding tax on the gross amount of certain payments is a convenient and effective method of collecting tax from nonresidents, especially for developing countries that lack sufficient administrative resources. However, unless the rate of tax is quite low, a final withholding tax is inappropriate for amounts in respect of which a nonresident is likely to have incurred significant expenses. This may be the case where amounts such as dividends, interest, or royalties constitute profits of a business carried on by a nonresident.

Another method of providing relief from excessive withholding taxes is allowing nonresidents to elect to pay tax on a net basis; if the election is made, the nonresident must file a return and pay tax on the net income. Several countries provide this type of election with respect to income from immovable property. A nonresident deriving rent from immovable property located in a country will often be subject to withholding tax on the gross amount of the rent. Although such a withholding tax on rental income from immovable property is in accordance with Article 6 of the OECD and UN Model Treaties, the nonresident may have incurred significant expenses with respect to the immovable property, such as mortgage interest, property taxes, and maintenance. As a result, a gross basis withholding tax, even at a relatively low rate, may well be excessive and the ability for the nonresident to make an election to pay tax on a net basis can provide relief.

An example of the tension between the effectiveness and the appropriateness of final withholding is the taxation of consulting, technical, and management fees by developing countries. Under the OECD and UN Model Treaties, such fees are business profits that are taxable by the source country only if the nonresident spends more than 183 days in the source country or has a PE or fixed base in the source country and the fees are attributable to the PE or fixed base. In most cases, taxpayers can arrange their affairs so that they can earn substantial fees without having a PE or fixed base in the source country (or without spending more than 183 days in the source country under Article 14(1)(b) of the UN Model Treaty).

This result is often unacceptable to developing countries, and some of them have taken the position that technical and management fees are royalties subject to withholding tax. Several countries, such as India, Jamaica, Kenya, Mongolia, Tanzania, and Vietnam, have included special articles in their tax treaties allowing them to tax consulting, technical, and management fees on a gross basis, but at a limited rate. The UN Committee of Experts is currently working on a new article dealing with consulting, technical, and management fees to be included in the UN Model Treaty. This new article would permit source countries to tax such fees through a withholding tax on the gross amount, but at a limited rate to be agreed on by the parties to the treaty. Such fees would be taxable by a country if the payer of the fees is a resident of the

country or a nonresident with a PE or fixed base in the country. The nonresident would not be required to meet any threshold (such as a PE or fixed base) and the source country would be entitled to tax even where the services are rendered outside that country. The proposed article on consulting, technical, and management services is dealt with more extensively in Chapter 9, section 9.3.

CHAPTER 6

Transfer Pricing

6.1 INTRODUCTION

A transfer price is the price established in a transaction between related persons. For example, if ACo manufactures goods in Country A and sells them to its foreign affiliate, BCo, resident in Country B, the price at which that sale takes place is called a transfer price. A transfer price may be different from the market price, which is the price set in the marketplace for transfers of goods and services between unrelated persons. In a sale of goods or services between unrelated parties, the conflicting interests of the parties usually ensure that the price charged for the goods or services is neither artificially high nor low. However, related parties do not have conflicting interests, and therefore the prices charged in transactions between related parties may be significantly different from market prices.

Multinational companies use transfer prices for sales and other transfers of goods and services within their corporate group. These intercompany prices are the most important category of transfer prices. Transfer prices may also used by individuals dealing with corporations or other entities under their control and by individuals dealing with close family members.

Unless prevented from doing so, related persons engaged in cross-border transactions can avoid tax through their manipulation of transfer prices. For example, in the example above, ACo might avoid paying income taxes in Country A by setting a price on the sale of its manufactured goods to BCo that results in its earning little or no profit. If the effective tax rate in Country B is lower than the effective tax rate in Country A, then the total tax burden on ACo and BCo would be reduced through the use of inappropriate transfer prices. If Country B is a low-tax country, then ACo and BCo would pay little or no tax on their combined profits.

In a well-designed income tax system, the tax authorities should have the power to adjust the transfer prices set by related persons if those prices differ from the market prices. This authority should include the power to allocate revenue, deductions,

credits, and other allowances among related persons so that the country is able to prevent the erosion of its domestic tax base and collect its fair share of tax revenue.

In general, related persons include persons that are owned or controlled, directly or indirectly, by the same interests. A good indicator of such a relationship is the ability to set transfer prices that differ from market prices.

As suggested above, the tax authorities should be given the power to adjust transfer prices to prevent taxpayers from shifting income to related persons resident in tax havens or in countries where they enjoy some preferential tax treatment. Examples of preferential tax treatment include a relatively low tax rate, a tax holiday or other tax incentive, and a tax-deductible loss. Although taxpayers generally do not seek to deflect income to a country that has high statutory tax rates, they may do so when a member of their affiliated group has losses in that country or if they are able to exploit some loophole or preferential tax regime in the high-tax country's tax system.

The tax authorities of a country also need the power to adjust transfer prices in order to prevent other countries from obtaining an unfair share of the tax revenue on income derived from cross-border transactions through overly aggressive enforcement of their transfer pricing rules. When one country is aggressive in making transfer price adjustments and another country is not, taxpayers engaged in transactions in both countries may divert income to the aggressive country in order to mitigate their risks of double taxation.

Double taxation is a serious possibility when multiple countries apply their transfer pricing rules. For example, assume that ACo manufactures goods in Country A at a cost of 60 and sells them to a related company, BCo, that is resident in Country B. BCo then sells the goods to retail customers in Country B for 150. ACo is taxable in Country A on its manufacturing profits and BCo is taxable in Country B on its sales profits. The corporate group (consisting of ACo and BCo) has a net profit of 90 (150 - 60). Assume that Country A concludes that the proper transfer price on the sales from ACo to BCo is 90, whereas Country B takes the position that the proper price for the sales is 50. In that event, double taxation will result because the combined group will have income of 90 but will be taxable on income of 130, as follows:

Income of ACo taxable in Country A:	
Sales	90
Cost of goods	60
Income	30
Income of BCo taxable in Country B:	
Sales	150
Cost of goods	50
Income	100
Total income of ACo and BCo	130

The double taxation illustrated in the above example would be eliminated if both countries had uniform rules for adjusting inappropriate transfer prices and applied

those rules in the same way in all cases. Thus, on the facts of the example, double taxation would be eliminated either if Country B accepted Country A's transfer price of 90 (because Country B would then tax BCo on income of only 60) or if Country A accepted Country B's transfer price of 50 (because then Country A would treat ACo as having a loss of 10).

In an attempt to achieve some degree of uniformity, Article 9 of both the OECD and UN Model Treaties provides that transfer prices should be adjusted to reflect the prices that would have been used in the same transaction between unrelated enterprises acting independently. This so-called "**arm's-length method (standard, principle, or approach)**" has been adopted by most countries of the world. The wide acceptance of the arm's-length method, however, masks substantial disagreements over the way the method is applied in practice. The main transfer pricing methods employed for implementing the arm's-length standard are described in section 6.4 below.

Some countries try to reach agreement with taxpayers on the methodologies to be used by them in setting their transfer prices before a transfer pricing dispute actually arises. A major objective of this type of approach is to reduce the high costs that taxpayers and the tax authorities typically incur in litigating disputes over transfer prices. A taxpayer that wants advance approval of its pricing methodology with respect to one or more transactions typically submits a request to the tax authorities for what is generally known as an "**advance pricing agreement**" or APA. The taxpayer must give details about the transfer pricing methodology that it intends to apply to the transactions covered by the APA and must explain why that methodology would produce an appropriate result. In some instances, two or more governments may use the dispute-resolution mechanism in their tax treaties to agree jointly on the pricing methodology to be used by a taxpayer. The OECD has issued guidelines for countries in developing joint APAs.

6.2 THE OECD TRANSFER PRICING GUIDELINES

Beginning in the 1960s, the United States (US) took the lead in developing techniques for limiting transfer pricing abuses. The definition of the arm's-length standard under section 482 of the US Internal Revenue Code was initially controversial, but is now widely accepted. The regulations under section 482 promoted three methods for determining the arm's-length price: the comparative uncontrolled price (CUP) method, the resale price method, and the cost plus method. In 1995, the US adopted new transfer pricing regulations that endorsed some additional methods, to be applied primarily when products embodying intangible property are sold or licensed. Although initially quite controversial, those methods have now been accepted by many other governments and, with some qualifications, have been endorsed by the OECD.

The OECD has been working steadily for many years to achieve an international consensus on transfer pricing rules. In 1979, the OECD published a report, *Transfer Pricing and Multinational Enterprises,* which advocated the adoption of the arm's-length standard to determine the prices of transactions between associated enterprises.

The 1979 report was supplemented by a 1984 report, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, which dealt with the mutual agreement procedure, banking, and the allocation of central management and service costs. In 1992, the OECD established a task force to review transfer pricing developments in the US; another task force was established in 1993 to revise the 1979 and 1984 reports on transfer pricing. These efforts culminated in a comprehensive and fundamental review of transfer pricing issues and the publication, in 1995, of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines).

The OECD Guidelines were published in loose-leaf format to accommodate subsequent revisions. Revisions to the Guidelines have been made on several occasions since 1995 (most recently in 2010), and more revisions are proposed as part of the OECD's BEPS project. For example, the chapters dealing with intangibles, **cost-contribution arrangements**, and documentation requirements are likely to be revised.

6.3 UNITED NATIONS, *PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES*

In 2013, the United Nations Committee of Experts published a *Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013). This Manual is intended to provide practical assistance to the tax authorities of developing countries in applying the arm's-length standard while recognizing the particular needs and administrative capacities of those countries. It is generally consistent with the OECD Transfer Pricing Guidelines. In addition to material on transfer pricing methods, documentation requirements, comparability analysis, and similar material that is also dealt with in the OECD Transfer Pricing Guidelines, the Manual deals with building capacity to handle transfer pricing issues in developing countries, audits and risk assessment techniques, and dispute resolution procedures, as well as a description of transfer pricing practices in Brazil, China, India, and South Africa.

6.4 THE ARM'S-LENGTH STANDARD

6.4.1 Introduction

According to international custom, an appropriate transfer price is one that meets the so-called arm's-length standard. This standard is met if a taxpayer sets its transfer prices in its dealings with related persons so that those prices are the same as the prices used in comparable dealings with unrelated persons.

The above definition of the arm's-length standard provides little guidance as to how transfer prices should be established in concrete situations. Some of the basic rules that countries have adopted to give content to the arm's-length standard are summarized below. Section 6.4.2 describes the identification of comparable arm's-length transactions or enterprises that are used to determine the appropriate arm's-length price for transactions between associated enterprises. Section 6.5 describes rules applicable to setting transfer prices when a group of related corporations shares

common resources. Section 6.6 describes the rules that apply to cost-contribution arrangements, under which related persons share the profits from the exploitation of intangible property that they have developed jointly.

The OECD Guidelines on transfer pricing strongly endorse the arm's-length standard. At the same time, they acknowledge frankly that the application of that standard sometimes presents serious difficulties for taxpayers and tax administrations. The Guidelines provide a valuable discussion of the factors to be considered in determining whether transactions between unrelated persons are comparable to the transactions actually entered into by members of a corporate group. Like most of the literature on the arm's-length approach, however, the OECD Guidelines are better at highlighting the problems of establishing the comparability of controlled and uncontrolled transactions than they are at giving practical advice to tax administrators on how to cope with these problems.

Many methods are used throughout the tax world for determining the arm's-length price for sales of tangible personal property. Five methods are discussed below. The first three methods - the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method - are sometimes referred to as the traditional methods and are widely accepted by the international tax community. Unfortunately, these methods are extremely difficult, if not impossible, to apply in many important cases, especially cases in which the products being sold incorporate valuable intangible property. The traditional methods are described in section 6.4.3 through 6.4.5 and compared in section 6.4.6.

The two other arm's-length methods can be applied in more situations. The **profit-split method** is frequently used on an informal basis by tax authorities in settling disputes with taxpayers through internal appeal procedures. The **transactional net margin method** (TNMM), also known as the **comparable profit method** (CPM), was formally approved by the US in revisions to the section 482 regulations, finalized in 1994. The OECD, in its 1995 Report on transfer pricing, suggests that the profit-split and TTNM methods should be used only as a last resort. They methods are described in sections 6.4.7 and 6.4.8.

6.4.2 Comparability Analysis

The essence of transfer pricing is determining the appropriate price for a non-arm's-length transaction based on a comparable arm's-length transaction. The arm's-length transaction used for comparison may be a transaction between the taxpayer (the person whose non-arm's-length transaction is being priced) and an arm's-length person (internal comparable) or between unrelated arm's-length persons (external comparables). For example, an enterprise may sell the same goods to both related and unrelated persons; therefore, the prices charged for the sales to unrelated persons may provide good comparables for determining the arm's-length price for the related-party sales. However, if the enterprise does not sell the same goods to unrelated parties, it would be necessary to search for an independent enterprise operating in the same market or industry that sells the same goods to arm's-length parties.

In most cases, it is impossible to find perfect comparables because arm's-length prices reflect many considerations (e.g., the quantity sold, the quality of the goods, terms of sale, the conditions of the market, the location of the market, etc). However, it is not necessary to identify precise comparables as long as it is possible to make adjustments to a transaction so that, with the adjustments, it becomes comparable.

All the transfer pricing methods discussed below require some type of comparability analysis. In the case of the traditional methods - CUP method, resale price method, and cost plus method - the key is to find a comparable transaction between arm's-length parties; however, in the case of a profit split or TNMM, the search is for a comparable independent enterprise rather than a comparable transaction. In both cases, comparability analysis is used to select the most appropriate transfer pricing method and apply that method to determine the arm's-length price.

The comparability of a related-party or controlled transaction and an arm's-length or uncontrolled transaction is usually based on five factors:

(1) the characteristics of the transferred property or services;
(2) a functional analysis of the parties to the transaction;
(3) the terms of the contract;
(4) the economic circumstances; and
(5) the business strategies pursued by the parties.

It is apparent from these factors that comparability analysis requires good information about the taxpayer and its business as well as the transactions involved.

Functional analysis is a key element in identifying useful comparable transactions. (It is also a key element in the attribution of profits to PEs under new Article 7 of the OECD Model Treaty (see Chapter 8, section 8.8.5)). Functional analysis involves an examination of the functions performed, assets used, and risks assumed by the parties to the relevant transaction, since these factors should determine the returns that the parties should expect from the transaction. Functions include research and development, manufacturing, purchasing, transportation, storage, marketing, and management services; assets include both tangible and intangible assets; risks include financial, product, collection, market, country/locational, and general business risks.

In many situations, reliable comparable transactions or enterprises may not be available for one reason or another, such as a lack of information or transactions involving new technology, for which there are no comparables.

6.4.3 Comparable Uncontrolled Price Method

The CUP method establishes an arm's-length price by reference to sales of similar products made between unrelated persons in similar circumstances. The CUP method is the preferred method if comparable sales exist. It is widely used for pricing oil, iron ore, wheat, and other goods sold on public commodity markets. It is also useful for pricing manufactured goods that do not depend substantially for their value on special know-how or brand names. However, it is not suitable for pricing many intermediate

goods, such as custom-made automobile parts, that are not generally sold to unrelated parties. Nor is it suitable for setting the price on sales of goods that are highly dependent for their value on the trade name of the producer. The operation of the CUP method is illustrated by the following example.

Assume that XCo is a corporation organized and resident in Country X. It manufactures wooden chairs in Country X at a cost of 40 and sells them to unrelated foreign distributors for 47 each. It also sells nearly identical chairs to YCo, a wholly owned foreign subsidiary resident in Country Y. YCo resells the chairs purchased from XCo to unrelated consumers at 70. If the conditions of the sales to YCo and the unrelated distributors are essentially equivalent, the arm's-length price for the sale of the chairs to YCo is 47. Thus, XCo would have a profit of 7 (47 - 40) from the intercompany sales, and YCo would have a profit of 23 (70 - 47).

The CUP method may be used even if the terms and conditions of the related-party sales are not identical to the sales to unrelated parties, as long as adjustments can be made to account for those differences. For example, if in the previous example the sales by XCo to unrelated distributors do not include delivery costs, whereas the sales to YCo do include delivery costs, the sales may still be considered to be comparable, although some adjustment must be made for freight and handling costs.

6.4.4 Resale-Price Method

The resale-price method sets the arm's-length price for the sale of goods between related parties by subtracting an appropriate markup from the price at which the goods are ultimately sold to unrelated parties. The paradigm case for its application is the sale by a taxpayer of its manufactured goods to a related party acting as a distributor, followed by a resale to unrelated customers without any further processing of the goods. The appropriate markup is the gross profit, expressed as a percentage of the resale price that distributors would typically earn from similar transactions with unrelated parties.

Assume that in the previous example XCo does not make any sales of furniture to unrelated parties and that no CUP is available. Assume also that the only activity performed by YCo is to resell the chairs in foreign markets. Under these assumptions, the resale price method might be appropriate for determining an arm's-length price for the chairs. Under the resale-price method, the first step is to determine the normal markup for a distributor engaging in activities similar to those performed by YCo. If independent foreign distributors earn commissions of 20 percent on the purchase and sale of products comparable to the wooden chairs, a 20 percent markup might be used to determine the arm's-length price on sales of chairs by XCo to YCo. Thus, if YCo sells the chairs to customers for 70 (the resale price), then the arm's-length price of the controlled sale between XCo and YCo under the resale-price method would be 56 (70 - 14 (20 percent of 70)). Thus, under the resale-price method, XCo would have an arm's-length profit of 16 (56 - 40) and YCo would have a profit of 14 (70 - 56).

6.4.5 Cost Plus Method

The cost plus method uses the manufacturing and other costs of the related seller as the starting point in establishing the arm's-length price. The seller's costs are then multiplied by an appropriate profit percentage and the result is added to the seller's costs to determine the arm's-length price. The profit percentage is determined by reference to the gross profit percentage earned by the seller in transactions with unrelated parties, or by comparable unrelated parties in similar transactions with unrelated parties. A paradigm case for the application of the cost plus method is a sale by a manufacturer of goods to a related party, with the related party affixing its brand name to the goods and reselling them to unrelated customers.

Assume that in the previous example XCo sells furniture to YCo without any brand name affixed to the furniture. YCo affixes its valuable brand name to the furniture and resells it to customers in foreign markets. In such circumstances, the cost plus method may provide the appropriate arm's-length price. Assume, for example, that the standard gross profit margin practice in the furniture manufacturing industry is 25 percent of the costs of production. XCo's average cost of producing furniture, determined under generally accepted accounting principles (GAAP), is 40. Under these assumptions, the arm's-length price under the cost plus method on sales of furniture by XCo to YCo is 50 (125 percent of 40).

It is not necessary for the gross profit margin to be based on the gross profit margins of other taxpayers engaged in the same activities, as long as adjustments are made to take account of the differences.

6.4.6 Comparison of Traditional Methods

In the examples above, XCo and YCo were engaged in entrepreneurial activities that could result in an overall gain or an overall loss. Under the CUP method, the entrepreneurial gain or loss is allocated between XCo and YCo by reference to comparable transactions between arm's-length parties. Under the resale-price method, the distributor, YCo, is guaranteed a profit and all the entrepreneurial gain or loss is allocated to XCo, the manufacturer. In the cost plus method, XCo is guaranteed a profit and the entrepreneurial gain or loss is allocated to YCo. Table 6.1 summarizes the income attributable to PCo and SCo under the three traditional methods.

Table 6.1 Income Attributable to PCo and SCo under the Three Traditional Methods

	CUP Method	*Resale Price Method*	*Cost Plus Method*
(1) XCo's cost of goods sold	40	40	40
(2) YCo's sales price to related customers	70	70	70
(3) Arm's-length transfer price	47	56	50

	CUP Method	*Resale Price Method*	*Cost Plus Method*
(4) Profit for XCo (Line (3) - Line (1))	7	16	10
(5) Profit for YCo (Line (2) - Line (3)	23	14	20
(6) Total profits to PCo and SCo	30	30	30
(7) Recipient of entrepreneurial profit	shared	PCo	SCo

When a multinational group of corporations is engaged in the manufacture and sale of products that embody valuable intangible property, it usually earns substantial entrepreneurial profits. The CUP method generally cannot be applied when the goods sold embody valuable intangible property because the goods sold are usually unique - there are no comparable transactions. In some cases, however, the conditions required for applying the resale-price method or the cost plus method may be met. If the manufacturer (XCo in the above example) is producing the goods in a low-tax country and the distributor (YCo in the above example) is selling those goods in a high-tax country, the corporate group is likely to favor the application of the resale-price method because that method allocates the entrepreneurial profits to the manufacturer in the low-tax country. In contrast, if the country of production is a high-tax country and the country of sale is a low-tax country, the corporate group would prefer to use the cost plus method, which allocates the entrepreneurial profit to the country of sale.

6.4.7 Profit-Split Method

Under the profit-split method, the worldwide taxable income of related parties engaging in a common line of business is allocated among the related parties in proportion to their contributions to earning the income. This method typically is employed when none of the three traditional methods can be applied. If a group of affiliated companies has more than one product line, the profit-split method might be applied separately to each product line. Indeed, there is a wide variety of ways that a profit-split method might be applied. A distinctive feature of the method is that it applies to aggregate profits from a group of transactions and not to individual transactions. The traditional methods, in contrast, are all based on individual transactions. The following example illustrates the application of a profit-split method.

XCo and YCo are related companies engaged in the production and sale of pharmaceuticals. XCo engages in extensive research activities and uses patented processes to manufacture the pharmaceutical products, which it sells to YCo. YCo repackages the products for retail sale, attaches its valuable trade name, and resells them through an extensive marketing operation. XCo does not make any sales to unrelated parties, and there are no comparable sales of equivalent products by other pharmaceutical companies.

Under these conditions, some countries might use a profit-split method to establish an appropriate transfer price for the pharmaceuticals. Assume that XCo incurs costs of 300 in manufacturing the drugs and YCo incurs costs of 100 in packaging, marketing and selling them. Assume also that the sales proceeds from aggregate sales by YCo to unrelated customers is 600. On these facts, the corporate group has net profits of 200 (600 - (300 + 100)). If XCo's contribution to the enterprise accounts for approximately 75 percent of the total net profits, then a 75/25 split of the profits might be appropriate. Thus, XCo would have profits of 150 and YCo would have profits of 50.

There are many possible variations of the profit-split method, including combining it with one or more of the traditional methods. For example, traditional methods might be used to allocate average profits from routine activities, and the profit-split method might be reserved for dividing entrepreneurial profits from the exploitation of valuable intangible property.

Assume in the example above that XCo engages in routine production activities and YCo engages in routine sales activities. XCo has gross costs of production of 300. Unrelated companies engaged in comparable manufacturing activities earn gross profit margins of 20 percent of costs. On these facts, XCo would have profits of 60 (20 percent of 300) allocated to it under the cost plus method. YCo has gross sales revenue of 600. Unrelated companies engaged in similar activities earn gross profit margins of 10 percent. Under the resale price method, therefore, YCo would have profits allocated to it of 60 (10 percent of 600). The remaining profits of 80 (200 - (60 + 60)) would be allocated under the profit-split method. Assuming that a 75/25 split is applied, then XCo would be considered to have profits of 60 (75 percent of 80) under the profit-split method, and total profits of 120 (60 + 60). YCo would be considered to have profits of 20 (25 percent of 80) under the profit-split method, and total profits of 80 (20 + 60).

For the profit-split method to operate fairly and effectively, some fair and effective method must be applied to determine the appropriate profit split. One approach used by the OECD is to examine profit splits between uncontrolled persons that are engaged in comparable activities. Unfortunately, such information is typically not available. Because the profit-split method is most likely to be applied when valuable intangible property is involved, a profit split based on the relative contributions of the related parties to the development of that intangible property might be appropriate.

6.4.8 Transactional Net Margin Method

Under the TNMM, (which can be viewed as the OECD equivalent of the US (CPM), the taxpayer must establish, either for itself or a related party (the tested party), an arm's-length range of profits for a set of transactions. If the tested party's reported profits from those transactions fall within that range, its transfer prices will be accepted by the tax authorities. If its profits fall outside that range, the tax authorities may adjust transfer prices so that the profits fall within the range, typically at the midpoint. Despite

the use of the term "transactional" in the name TNMM, TNMM is not a transaction method for determining arm's-length transfer prices. Instead, TNMM is based on an entity's profits from a group of transactions and not on the prices for particular transactions, which is the focus of the traditional transfer pricing methods.

In general terms, the profits of a tested party are determined by determining the ratio of profits to some economic indicator for an unrelated person and then applying that ratio to calculate the profits of the tested party. Assume, for example, that an unrelated person has taxable income of 80 and invested capital of 800, and that invested capital is the economic indicator used in applying TNMM. The ratio of taxable income to invested capital for the unrelated person is 80:800, or 10 percent. If the tested party has invested capital of 500, then under a simplified version of TNMM, its arm's-length profits will be 50 (500 × 80/800).

To refine the application of TNMM, the taxpayer or the government might make TNMM calculations for more than one unrelated person. The more such calculations are made, the more reliable the results are likely to be. The arm's-length profits of the tested party are an amount falling within the range of profits determined under the several calculations. Statistical techniques might be applied to select the point within that range that would be deemed to be the tested party's arm's-length profits. If the tested party is a related corporation rather than the taxpayer, then the profits of the taxpayer are determined by subtracting the profits of the tested person, as determined under TNMM, from the combined profits of the two corporations.

Whether the taxpayer or a related person is used as the tested party depends on the facts and circumstances of each particular case. The objective is to have, as the tested party, the related corporation that is most similar with respect to its business functions to the unrelated corporations that are used as comparables. For example, assume that ACo manufactures goods in Country A, sells the goods to BCo, its wholly owned subsidiary, and BCo sells the goods in Country B after affixing its valuable trade name to those goods. If information necessary for applying the traditional pricing methods or for applying TNMM to ACo is not available, such information for applying TNMM to BCo might be available. If so, BCo would be the tested party, whether or not it is the taxpayer.

To apply TNMM, a taxpayer must determine a range of profits that unrelated persons would be expected to earn from engaging in comparable transactions. The taxpayer can establish this range in a variety of ways. One way, illustrated above, is to determine the rate of return on capital employed by two or more unrelated parties engaging in activities that are broadly similar to the activities of the taxpayer. This rate of return on capital for each unrelated person is then multiplied by the amount of capital of the taxpayer (or tested party, as the case may be). An alternative approach is for the taxpayer to determine the ratio of operating profits to gross sales receipts for two or more comparable related persons and then apply these ratios to its own (or the tested party's) sales. A third way is to determine the ratio of gross profit to operating expenses for two or more related persons and apply these ratios to the taxpayer's or the tested party's operating expenses. Other economic indicators might also be used.

Assume, for example, that ACo, the tested party, is engaged in business activities similar in complexity and character to the activities of XCo and YCo, corporations

unrelated to ACo and to one another. XCo and YCo have ratios of operating profits to gross receipts of 0.2 and 0.3, respectively. ACo has gross receipts of 200,000. Under TNMM, ACo's arm's-length range of profits would be from 40,000 (200,000 × 0.2) to 60,000 (200,000 × 0.3). Assuming that the various conditions for application of TNMM are met, ACo's arm's-length profits would be considered to be in the range of 40,000 to 60,000.

Once the TNMM range has been established, it is necessary to select some amount within that range as the arm's-length profits of the tested party. In general, the tax authorities would probably accept the transfer prices shown in the taxpayer's books and records if the profits determined by using those prices fall within the TNMM range. If the taxpayer's reported profits fall outside the range, the tax authorities are likely to treat the midpoint of the range as the arm's-length profits. If data for more than two unrelated persons is used to establish the TNMM range, then a weighted average of the resulting profit numbers would be used to establish the midpoint of the range.

TNMM can be manipulated, by the taxpayer or the tax authorities, through the choice of comparable companies. To prevent systemic biases in favor of either the taxpayer or the tax authorities, criteria need to be developed for selecting appropriate comparable companies. In addition, neutral rules should be applied to eliminate comparable companies that yield unreasonable results and to select the arm's-length profits from within the TNMM range.

6.5 SHARING OF CORPORATE RESOURCES

6.5.1 Introduction

Related corporations frequently share funds, credit lines, corporate headquarters, know-how, trade names, employees, and other corporate resources. The arm's-length standard requires that the owner of the shared resources charge related parties an arm's-length fee for their use. In theory, the fee should equal the amount that the owner of an equivalent resource would charge an unrelated party for its use. In practice, the appropriate arm's-length price is difficult to determine, in part because unrelated corporations do not often share comparable resources.

6.5.2 Loans or Advances

A group company engaged in the business of making commercial loans should be required to use a rate of interest for loans or advances to related parties that reflects the current cost of borrowing. For a group company that is not in the business of making loans, some countries provide a safe-harbor interest rate so that the interest rate charged on the loan will not be adjusted if it is within the safe harbor. For example, a country may allow taxpayers to use an interest rate pegged to the average cost of government borrowing.

6.5.3 Performance of Services

If marketing, managerial, administrative, technical, or other services are performed by one person for the benefit of a related person, the person providing the services should charge an amount that an independent service provider would charge for the same services. If no comparable arm's-length services are available, the arm's-length fee might be based on the cost of providing the services plus an appropriate profit. However, the problem of setting an appropriate arm's-length price in these circumstances is formidable.

6.5.4 Use of Tangible Property

If tangible property, such as an office or equipment, is made available by a person to a related person, the owner of the property should charge the user an arm's-length rental fee. The same rule should apply to subleases of tangible property.

6.5.5 Use or Transfer of Intangible Property

If intangible property, such as a patent or trademark, is made available to a related party, the owner of the property should charge whatever amounts would be charged to an unrelated person for the use of the property in similar circumstances. This charge might be set by reference to royalty rates charged by the owner on the same or similar property made available to unrelated parties. However, obtaining the data necessary to determine the proper arm's-length royalty is often difficult, both for the tax authorities and the taxpayer, and multinational companies are commonly accused of avoiding tax through the use of inappropriate royalty rates.

If intangible property is sold to a related person, the arm's-length sales price can be established by reference to the discounted value of the arm's-length royalties anticipated over the life of the property.

In 1986, the US adopted legislation requiring that royalty rates charged between related parties be commensurate with the income from the intangible property. Under the arm's-length standard, royalty rates generally are based on facts known or knowable at the time the license for the use of the property is concluded. The commensurate-with-income standard requires periodic adjustments in royalty rates to reflect the actual experience of the parties in utilizing the intangible property. For example, if XCo, a US corporation, transfers patents and know-how to its Irish subsidiary that allows it to manufacture plastic contact lenses, under the commensurate-with-income standard, the parties may be required to make periodic adjustments in the royalty charged for use of that property to reflect the level of profits earned by the Irish subsidiary from the manufacture and sale of the contact lenses.

Despite their potential, the US commensurate-with-income rules have not been effective in curbing transfer pricing abuses. The OECD has endorsed the limited application of a commensurate-with-income standard where unrelated persons operating at arm's length would not have made an outright sale or long-term license of

intangible property. For example, a multinational enterprise with unique and valuable intangible property would never sell or lease that property to an unrelated party. In these circumstances, it is more appropriate to ignore the related-party sale or license and substitute a different arrangement, under which the transferor is entitled to a substantial share of the actual profits earned through use of the transferred intangible property. See section 6.7 below, describing the circumstances in which the tax authorities are permitted to recharacterize the actual transactions entered into by associated enterprises.

The OECD's BEPS Action 8: *Guidance on Transfer Pricing Aspects of Intangibles* proposes extensive revisions to the OECD Transfer Pricing Guidelines, especially Chapter 6 dealing with the basic treatment of intangibles for transfer pricing purposes. These revisions clarify the definition of intangibles and provide guidance for identifying transactions involving intangibles and determining the arm's-length conditions for cases involving intangibles. The revisions also include several examples that illustrate the application of the guidelines to intangibles. This work will not be finalized until the related BEPS work on intangibles is completed.

6.6 COST-CONTRIBUTION ARRANGEMENTS

If a group of corporations intends to develop valuable intangible property and share the benefits among two or more of its members, it can avoid transfer pricing issues by having all the prospective users of the intangible property jointly develop that property through a **cost-contribution** or **sharing arrangement**. In that situation, all the contributors to the development of the property have rights to the profits generated by the property in proportion to their contributions, and no transfer of the property or rights to the use of the property between members of the corporate group is required. Cost-contribution arrangements are dealt with in Chapter 8 of the OECD Transfer Pricing Guidelines. In general, the OECD rules are designed to recognize bona fide cost-contribution arrangements, but limit their use for tax avoidance purposes.

For a cost-contribution arrangement to be consistent with the arm's-length standard, it should have the following characteristics:

- The arrangement should be embodied in a legally enforceable written contract entered into when the arrangement was initially established that clearly establishes the nature of the arrangement, its duration, and the terms for its enforcement and amendment.
- Only persons with a legitimate expectation of benefiting under the arrangement should be permitted to be participants.
- The contract should require the participants to the arrangement to contribute to the costs of development of the intangible property in proportion to the benefits that they might reasonably be anticipated to derive from the use of that property.

- The participants to the arrangement should be required to keep adequate records documenting their costs and explaining how their anticipated benefits were calculated.

Assume, for example, that ACo and BCo are related corporations engaged in manufacturing small electrical appliances. ACo is engaged in business in Country A and BCo is engaged in business in Country B. ACo and BCo intend to develop new technology that would allow them to manufacture their appliances at a lower cost. They enter into a written contract that assigns to ACo the rights to exploit any intangible property developed under the agreement in Country A. BCo receives similar rights with respect to Country B. ACo has current sales of appliances in Country A of 400, and BCo has sales in Country B of 600; that general pattern is expected to continue in the future. Under the cost-contribution arrangement, ACo agrees to pay 40 percent of the costs and BCo agrees to pay the remaining 60 percent. They both agree to keep detailed accounting records with respect to their costs and their sales.

Assuming that County A has adopted rules for cost-contribution arrangements similar to those in the OECD Guidelines, the arrangement between ACo and BCo would qualify as a bona fide cost-contribution arrangement. Country A should permit ACo to take a deduction for payments made under that arrangement under the rules generally applicable to amounts paid to develop intangible property. In addition, ACo should be treated as a coowner of the resulting intangible property; therefore, ACo should not be treated as paying a deemed royalty to BCo under the transfer pricing rules of Country A. If ACo makes an actual royalty payment to BCo, that payment should not be deductible.

As part of BEPS Action 8 dealing with transfer pricing, the OECD has proposed revisions to Chapter 8 of the Transfer Pricing Guidelines dealing with cost-contribution arrangements. In general terms, the arm's-length standard requires each participant's contribution to a cost-contribution arrangement to be consistent with its share of the expected benefits from the arrangement. For this purpose, the revised Guidelines will require each participant's contribution to be based on its value rather than on its cost unless, in certain limited circumstances, cost is a reliable indicator of the value of contributions.

The rules governing cost-contribution arrangements among related persons should permit the participants to modify an arrangement to reflect changed economic circumstances. To conform to the arm's-length standard, however, those rules should require that the participants receive a payment equal to the fair market value of any rights that they may have relinquished and that they pay a fair market fee for any new rights obtained. If a new participant is brought into a cost-contribution arrangement, that participant should be required to compensate the other participants for the fair market value of the dilution of their interests in the arrangement. Any revision of a qualifying cost-contribution arrangement should be in writing and otherwise conform to the requirements for a new cost-contribution arrangement.

To prevent tax avoidance, governments should have the authority to treat related persons as if they had entered into a cost-contribution arrangement when their economic behavior is consistent with such an arrangement. Assume, for example, that

ACo and BCo are related persons and have jointly developed some intangible property. However, they have not entered into a cost-contribution arrangement. ACo makes use of the intangible property in its business in Country A and pays a royalty for that use to BCo, a resident of Country B. Under the tax treaty between Country A and Country B, the royalty is not subject to withholding tax by Country A because the treaty contains an article similar to Article 12 of the OECD Model Treaty, giving the exclusive right to tax royalties to the residence country. ACo claims a deduction for the royalty payment in computing its income taxable in Country A. Country A should have the authority to treat ACo and BCo as having entered into a constructive cost-contribution arrangement, with the result that ACo would not be permitted to take a deduction for the royalty payment to BCo.

Cost-contribution arrangements have been widely used to shift profits to low-tax countries. This result is possible largely because multinational enterprises have access to information about their intellectual property and research and development activities that is not available to the tax authorities. Therefore, for example, a group company in a low-tax country might enter into a cost-contribution arrangement with another group company in a high-tax country; the high-tax country would allow the first company to acquire rights to research that is disproportionately profitable compared to all the research and development activities of the group.

6.7 DISREGARDED TRANSACTIONS

The OECD Transfer Pricing Guidelines emphasize that the tax authorities must accept the actual transactions entered into by associated enterprises and apply the transfer pricing rules to those transactions. However, in two narrow circumstances, the OECD Guidelines permit the tax authorities to ignore the legal transactions entered into by related enterprises and allocate the profits between the enterprises on a different basis. First, if the economic substance of the actual transaction differs from the legal form of the transaction, the transaction may be recharacterized by the tax authorities in accordance with its substance and taxed on that basis. For example, depending on the circumstances, including its terms, a loan to an associated enterprise might be recharacterized as equity. Second, if the arrangements entered into by the associated enterprises would not have been entered into by arm's-length parties, the tax authorities may recharacterize the arrangements in accordance with what arm's-length parties would have done. For example, a multinational enterprise with valuable intangible property would not sell or lease that property on a long-term basis to an unrelated enterprise without some price-adjustment mechanism allowing the transferor to share in future profits.

These exceptional circumstances, in which the tax authorities can disregard actual transactions, are strikingly similar to anti-avoidance rules. It is questionable whether the tax authorities have the power to recharacterize transactions, as provided in the OECD Guidelines, without explicit statutory authority in domestic law. Part of the OECD's BEPS Action 10 involves clarifying the circumstances in which transactions between associated enterprises can be recharacterized in order to prevent base erosion.

6.8 TRANSFER PRICING DOCUMENTATION REQUIREMENTS

Many countries have attempted to deal with perceived transfer pricing abuses by requiring multinational companies to provide the tax authorities with extensive, contemporaneous documentation to support the methods used to establish their transfer prices. The idea is that by forcing multinational companies to establish their transfer prices in advance, a country can prevent after-the-fact shifting of income for tax avoidance purposes. Taxpayers failing to provide the requisite documentation may be subject to substantial penalties.

For example, assume that ACo, operating in Country A, is selling goods to BCo, a related corporation operating in Country B. The corporate tax rate is 40 percent in Country A and 20 percent in Country B. ACo and BCo set the transfer prices for their intercompany sales so that there is a small profit in Country A and a large profit in Country B. After setting those prices and providing the documentation to Country A, ACo discovers that it will suffer a large tax loss in Country A from some unrelated operations. If its pricing methodology had not been fixed, ACo might have been strongly tempted to revise the methodology to deflect some income from Country B to Country A so that it could fully utilize the Country A loss. The contemporaneous documentation rules, however, may prevent such a revision.

The OECD Guidelines support the dual strategy of requiring contemporaneous documentation and penalizing taxpayers for failure to comply with the documentation requirements. However, tax administrators are advised to pursue that strategy with extreme caution so as to avoid imposing unfair or excessively burdensome obligations on taxpayers acting in good faith.

Action 13 of the OECD's BEPS project proposes important enhancements to the existing transfer pricing documentation requirements. Multinational enterprises will be expected to provide the tax authorities of all countries in which they do business with a master file containing general information about their business operations and their transfer pricing practices and policies. In addition, each country must be provided with a local file containing information with respect to any related-party transactions occurring in the country. Most important, multinationals will be required to provide an annual report to each country in which they operate setting out the amount of revenue, profit, and taxes accrued and paid with respect to that country. Although these country-by-country reports will not require information to be provided on an entity-by-entity basis, they should nevertheless provide the tax authorities with an important tool with which to apply their transfer pricing rules more effectively.

Countries can limit the most egregious forms of transfer pricing abuses by giving appropriate discretion and resources to their tax departments and by imposing stiff penalties on taxpayers that have not set their transfer prices in good faith. They can take away some of the incentive for transfer pricing abuses by setting their marginal tax rates at levels that are moderate by international standards. Adoption of specific legislation targeted at tax havens can also take away some of the incentive for transfer pricing abuses because taxpayers commonly set improper transfer prices in order to deflect their income to affiliated entities in tax havens. Chapter 7 describes such anti-avoidance provisions. Countries can also obtain help in controlling transfer pricing

abuses through cooperation with their tax treaty partners, particularly their close neighbors. However, despite determined efforts by national tax authorities and increased cooperation with their trading partners, transfer pricing continues to be a serious ongoing problem.

6.9 TREATY ASPECTS OF TRANSFER PRICING

The provisions of the OECD and UN Model Treaties do not deal with the problem of transfer pricing in any detailed way. Article 9(1) of both Model Treaties authorizes an adjustment to the profits of an enterprise that is associated with another enterprise if "conditions are made or imposed between the two enterprises which differ from those which would be made between independent enterprises." Literally, therefore, Article 9(1) focuses on the terms and conditions of related-party transactions, rather than just on the prices charged in specific transactions.

Article 9 is entitled "Associated Enterprises." It applies if an enterprise of one contracting state participates directly or indirectly in the management, control, or capital of another enterprise in the other contracting state or if the same persons participate directly or indirectly in the management, control, or capital of two or more enterprises in the contracting states. Beyond this wording, Article 9 does not define "associated enterprises"; as a result, whether enterprises are associated must be determined in accordance with domestic law. Most countries apply their transfer pricing rules to transactions between enterprises where one enterprise controls the other, or where they are both controlled by another person and control is considered to be the ownership of more than 50 percent of the shares or interests in an entity.

Article 9(1) of both the OECD and UN Model Treaties provides that the profits that would have accrued to an enterprise, but did not because of non-arm's-length transactions with associated enterprises, "may be included" in the profits of the enterprise. Thus, read literally (and unlike other treaty provisions), Article 9(1) is not worded as a mandatory provision ("shall be included") that the contracting states must apply. Some commentators argue that, as a result of the permissive wording of Article 9(1), contracting states are entitled to tax resident enterprises on profits that are more or less than their profits in accordance with the arm's-length standard. For example, if ACo, a resident of Country A, charges its subsidiary, BCo, resident in Country B, 100 for goods or services that have an arm's-length price of only 75, Country A is not required by Article 9(1) to unilaterally reduce the price to 75. Conversely, if the arm's-length price of the goods or services is 125, Country A is not required by Article 9(1) to increase the price to 125, although in most circumstances it will want to do so.

On this view, Article 9(1) is merely a statement of principle about the determination of the profits of associated enterprises in accordance with the arm's-length standard. However, Article 9(2) of both the OECD and UN Model Treaties requires a country to make adjustments to the transfer prices used to compute taxable income of their taxpayers if those prices have been adjusted by the other contracting state in accordance with the arm's-length standard.

Assume, on the facts of the previous example, that Country A adjusts the price at which ACo sells its manufactured goods to its foreign affiliate, BCo, from 60 (the actual sales price) to 90 (the price that Country A considers that arm's-length parties would have charged). Therefore, Country A will increase ACo's taxable income by 30. If Country B concurs with Country A's determination of the proper transfer price, it should allow BCo to increase its actual cost of acquiring the goods by 30 (60 + 30 = 90) and reduce its taxable income accordingly, to 60. An adjustment of a transfer price used by one taxpayer to take into account an adjustment made by another country to the transfer price used by an affiliated taxpayer is referred to as a "**corresponding adjustment**".

It is arguable whether profit-based transfer pricing methods, such as the profit-split method and TNMM, are consistent with the language of Article 9(1). The reference to profits in Article 9(1) could be a reference to all profits, or just the profits from particular transactions or types of business. In any event, by endorsing the profit-based methods, the OECD Transfer Pricing Guidelines clarify that those methods are acceptable in certain circumstances under Article 9.

Conflicts between countries over transfer prices are commonplace, despite the fact that all countries have agreed in their bilateral tax treaties to adhere to the arm's-length standard. Most tax treaties provide that an enterprise that is subject to double taxation because of inconsistent transfer prices may seek redress through the mutual agreement procedure. Under that procedure, the competent authorities are required to try and deal with the taxpayer's complaint, but they are not generally obligated to resolve it. A few newer treaties include a procedure for binding arbitration. For a discussion of the mutual agreement procedure for resolving treaty disputes and arbitration, see Chapter 8, sections 8.8.3 and 9.5, respectively.

6.10 TAX POLICY CONSIDERATIONS: FORMULARY APPORTIONMENT AND THE FUTURE OF THE ARM'S-LENGTH METHOD

To be blunt, the current transfer pricing rules based on the arm's-length standard do not work effectively, despite decades of practical experience and refinement. Although there are many reasons for the failure of arm's-length transfer pricing rules, the most fundamental reason is that the underlying assumption – that the separate parts of a multinational enterprise can be considered to behave as if they were independent – is patently false. Multinational enterprises exist because there are economic and financial advantages to the economic integration of their activities. However, transfer pricing in accordance with the arm's-length standard ignores the economic integration of a multinational enterprise's activities, but respects its legal structure and the legal form of its intercorporate transactions.

The arm's-length standard has received considerable criticism from academic commentators, from taxpayers directly affected by the standard, and from tax administrators. Taxpayers complain that it often imposes unreasonable burdens of proof on them, that it presents them with problems of double taxation not resolved by the competent authority mechanism of tax treaties, and that frequently it is not followed by

the tax authorities during audits. The tax authorities complain that the arm's-length standard allows considerable undertaxation of taxpayers engaged in cross-border transactions, that it encourages taxpayers to take aggressive positions on their tax returns in the hope of avoiding detection or of striking a favorable bargain on audit, and that it is extremely time-consuming and expensive to enforce. Some academics contend that, in some cases, the arm's-length method necessarily produces improper results because it cannot account for the profits that related corporations typically enjoy from conducting an integrated business. All of these criticisms are valid.

Although arm's-length transfer pricing is generally acknowledged to be seriously and irreparably flawed, it has one very important advantage - namely, that it is widely accepted. The transitional costs in moving to a different, even if better, system would likely be enormous. Moreover, it is not clear that there is a better system. Some commentators argue that the profits of multinational groups should be allocated among the members of the group based on profit-split methods. In fact, as noted above, the OECD Transfer Pricing Guidelines currently recognize the use of profit splits in certain circumstances and, in practice, it would appear that they are used increasingly to resolve transfer pricing disputes. The difficulty with profit-split methods is that it is unclear on what basis the profits of a multinational enterprise should be allocated to the countries in which it does business.

The alternative to the arm's-length approach that is most frequently advanced is a global **formulary apportionment system**. In a formulary apportionment system, affiliated entities engaged in a common enterprise are taxed as if they were a single entity. The worldwide income of the enterprise is attributed by a predetermined formula among all the countries where the enterprise engages in meaningful economic activity. Assuming that all countries could agree on the use of this system and could also agree on a reasonably uniform definition of taxable income, multinational corporations would be taxable once, and only once, on their worldwide income.

For example, in the case of a multinational enterprise engaged in the manufacture and sale of goods, an apportionment formula might allocate some fraction - perhaps one-half - of the income of the enterprise among the countries in accordance with the sales in those countries. The remaining part of the income would be apportioned among the countries where the manufacturing is conducted, with the allocation based on the total manufacturing assets or the payroll of the enterprise, or some combination of these two factors. Little or no income would be apportioned to any group entity in a tax haven unless sales or manufacturing activities take place in that country.

There are obviously many problems with the use of formulary apportionment as a means of allocating profits among related corporations. The arbitrariness of predetermined formulas makes it difficult to take into account the particular circumstances of each multinational enterprise. It relies heavily on access to foreign-based information. It almost guarantees that the amount of profits attributed to each member of a multinational group will differ, sometimes markedly, from the income shown on its books of account, even if those books are kept in good faith and in accordance with approved accounting methods. Substantial cooperation among governments is necessary to solve these problems, and it is unlikely that countries would be able to agree on a common apportionment formula.

Nevertheless, formulary apportionment has some attractive features. A well-designed system can eliminate the tax advantages of low-tax countries without the need for complex, difficult-to-administer controlled foreign corporation (CFC) rules. Formulary apportionment also avoids some of the difficult audit problems that frequently arise under the arm's-length approach. Unlike the arm's-length approach, it does not require separate agreement on the source of gross income and deductions in order to avoid double taxation because source rules are implicitly incorporated into the apportionment formulas. Although it is sometimes argued that formulary apportionment would be better for developing countries than arm's-length transfer pricing, this claim is questionable. The use of factors such as sales, property, and employees or payroll in the formula are unlikely to result in the allocation of substantial income to developing countries.

In comparing the formulary apportionment method to the arm's-length method, it is useful to contrast the treatment of income from intangible property under the two approaches. Under formulary apportionment, all income, including income derived from intangibles, would be apportioned to the countries in which goods are produced and sold. In contrast, under the arm's-length method, such income is allocated to the entity owning the intangible property. Ownership rights within a corporate group, however, have little economic significance. As a result, under the arm's-length method, it is frequently possible for a multinational enterprise to avoid tax on income from intangibles by shifting ownership of the intangibles to an affiliated corporation in a low-tax country.

Formulary apportionment has an undeservedly bad reputation, largely for political reasons. A sensible discussion of that method and the alternatives to it must go beyond labels and preconceived ideas. Moreover, the arm's-length standard and formulary apportionment should not be seen as polar extremes – instead, they should be viewed as part of a continuum of methods ranging from CUPs to predetermined formulas.

A formulary apportionment system uses an arm's-length approach in some circumstances, and the arm's-length approach sometimes uses formulas (profit splits). Recent refinements in the arm's-length approach rely increasingly on formulas, and that trend seems to be gaining international acceptance. Consequently, it is sometimes unclear where the arm's-length principle ceases and formulary apportionment begins. Applying pejorative and misleading labels to either approach is counterproductive.

Despite its deficiencies, the arm's-length standard is likely to continue to be the internationally accepted approach for resolving transfer pricing issues, except in special circumstances. As the earlier discussion of pricing methodologies indicates, however, the arm's-length standard is vague and has been interpreted to accommodate pricing methodologies, such as the profit-split method and TNMM, that seem closer to formulary apportionment than to an arm's-length approach.

Formulary apportionment is used in some federal countries (e.g., Canada and the US) to allocate the income of an entity among the subnational governments. It has been proposed for internal use within the North America Free Trade Agreement and the European Union. For several years, the European Union has been exploring the possibility of adopting some type of formulary apportionment to deal with the complex

problems that Member States encounter in determining the amount of income derived by corporations from activities occurring within their borders. However, agreement on a common consolidated tax base has been elusive.

The OECD has approved the use of formulas for apportioning the income of corporate groups engaged in global trading, banking, and insurance. Therefore, current transfer pricing rules are a mix of arm's-length methods and formulary apportionment methods. Given the deficiencies of both the arm's-length method and formulary apportionment, as well as the difficulty of changing the existing system, it seems likely that transfer pricing will continue to be a complex mixture of rules that, despite continuous refinement, will never deal with the underlying problem in a satisfactory manner.

CHAPTER 7
Anti-avoidance Measures

7.1 INTRODUCTION

International transactions provide many opportunities for the avoidance of tax. In this context, tax avoidance must be distinguished from **tax evasion**, which is illegal and usually involves the intentional nondisclosure of income or fraud. **Tax avoidance** is difficult to define precisely, but generally means transactions or arrangements entered into by a taxpayer in order to minimize the amount of tax payable in a lawful manner.

The ways of avoiding tax through international transactions are far too numerous to itemize. The following examples, however, illustrate the range of possibilities:

- A taxpayer can shift his or her residence from one country to another country that levies lower or no taxes.
- A taxpayer can divert domestic source income to a controlled foreign entity, such as a trust or a corporation, established in a tax haven.
- A taxpayer can establish a tax haven subsidiary to earn foreign source income or to receive dividends from subsidiaries in other foreign countries.
- If advantageous treaties exist, a taxpayer can route dividends, interest, royalties, and other amounts through subsidiaries established in foreign countries in order to reduce the amount of withholding tax on such amounts.

Not surprisingly, most countries have anti-avoidance rules to deal with certain types of international tax avoidance, and some countries still have exchange controls to regulate foreign investments and transactions by residents. Although these controls can be effective in preventing international tax avoidance, over the past several decades countries have abandoned exchange controls in favor of the free movement of capital.

Countries that do not use exchange controls employ a wide variety of tax measures to combat international tax avoidance. Some important examples of such

measures are described briefly below, with references in some instances to more detailed treatment elsewhere in the Primer.

Anti-avoidance rules and doctrines. Many countries have judicial anti-avoidance doctrines or statutory anti-avoidance rules under which transactions may be disregarded for income tax purposes. These doctrines and rules apply generally to tax avoidance transactions or arrangements, including international transactions. Judicial anti-avoidance doctrines include the sham transaction, substance-over-form, business purpose, step transaction and abuse of law doctrines. For example, the existence of a holding company established in a tax haven may be disregarded as a sham if it does not engage in any genuine commercial activities. Statutory anti-avoidance rules include specific and general anti-avoidance rules. Specific anti-avoidance rules include transfer pricing rules, thin capitalization and earnings-stripping rules, controlled foreign corporation (CFC) rules, and foreign investment fund rules. General anti-avoidance rules (often referred to by the acronym "GAAR") are intended to be sufficiently broad to deal with most or all types of abusive tax avoidance, including international tax avoidance transactions. Typically, GAARs apply when the principal purpose or one of the principal purposes of a transaction or a series of transactions is to avoid tax and the transaction abuses, frustrates, or defeats, or is inconsistent with, the object and purpose of the relevant tax legislation.

Special tax haven provisions. Some countries have specific provisions designed to deal with particular tax haven abuses. For example, Germany imposes a special tax on persons who move their domicile to a tax haven. Other countries disallow the deduction of interest and royalty payments or payments for services made to a tax haven entity unless the taxpayer establishes that the transactions are genuine; in other words, the onus of proof is placed on the taxpayer to justify such deductions.

Transfer pricing rules. Most countries have intercompany or transfer pricing rules to prevent related taxpayers from carrying out transactions at artificially high or low prices in order to shift income and expenses from one country to another. It is arguable whether these rules are properly classified as international anti-avoidance rules or whether they are just part of a country's basic tax system. Transfer pricing rules are discussed in detail in Chapter 6.

CFC rules. Several countries have adopted CFC rules to prevent the diversion of passive and certain other income to, and the accumulation of such income in, a CFC established in a tax haven. These rules are discussed in section 7.3 below. Some countries have similar rules with respect to foreign trusts.

Foreign investment fund rules. Several countries have adopted foreign investment fund rules to prevent the deferral of domestic tax by residents investing in foreign mutual funds, unit trusts, or similar entities. These rules are discussed in section 7.4 below.

Anti-treaty shopping rules. Several countries insist on the inclusion of provisions in their tax treaties and/or in their domestic legislation to prevent treaty shopping. Treaty shopping typically involves the establishment of a legal entity in a country by

nonresidents in order to obtain the benefits of the country's tax treaties. Treaty shopping is discussed in Chapter 8, section 8.8.2.2.

Thin capitalization and earnings-stripping rules. Several countries have adopted **thin capitalization** and **earnings-stripping rules** to limit the deduction of interest by resident corporations and other legal entities. Thin capitalization rules are intended to prevent nonresident shareholders of resident corporations from using excessive debt capital to extract corporate profits in the form of deductible interest rather than non-deductible dividends. Earnings-stripping rules are more broadly targeted at resident corporations and other entities that claim disproportionately large interest deductions. These rules are discussed in section 7.2 below.

Taxation of gains on transfers of property abroad and on expatriation. When appreciated property - property with an accrued gain - is transferred to a related nonresident, some countries deem the property to have been sold for its fair market value so that the accrued gain is subject to tax. Otherwise, domestic tax on the gain might be avoided entirely. Further, some countries impose tax on accrued gains when a taxpayer ceases to be resident or for a temporary period after a taxpayer ceases to be resident; such exit or departure taxes and trailing taxes are discussed in Chapter 3, sections 3.4.1 and 3.4.2.

Back-to-back arrangements. **Back-to-back arrangements** are commonly used as a tax planning device to obtain tax benefits that would not otherwise be available to a taxpayer directly. For example, a country may have rules dealing with related-party transactions; these rules can sometimes be avoided by inserting an arm's-length intermediary between the related parties. Similarly, the benefits of a country's treaties, such as reductions in withholding taxes, may be inappropriately obtained through back-to-back arrangements. Such arrangements are particularly common with respect to financial transactions, since funds can be funneled through an arm's-length financial institution with relative ease. For example, assume that Country A exempts interest payments by corporations resident in Country A to arm's-length nonresidents from its withholding tax on interest. If ACo, a corporation resident in Country A, pays interest to BCo, a related corporation resident in Country B, the interest would be subject to Country A's withholding tax. However, if BCo puts funds on deposit with a financial institution that deals at arm's length with both ACo and BCo and the financial institution loans an equivalent amount to ACo, Country A's withholding tax would not apply to the interest payments by ACo to the financial institution.

Hybrid entities and hybrid financial instruments. A "hybrid" arrangement refers to situations in which two countries treat entities, transactions, or arrangements differently and the different treatment is exploited to produce tax benefits. For example, if one country treats preferred shares issued by a resident corporation in accordance with their legal form as shares on which dividends are paid, but another country treats the shares as debt on which is interest is paid, this inconsistent treatment can be exploited to produce tax savings. If the country in which the corporation is resident treats the payments on the shares as interest, the payments will be deductible

and reduce that country's tax base. If the country in which the recipient of the payments is resident treats the payments as dividends, it may exempt those dividends from tax as a result of its participation exemption. Hybrid arrangements are discussed in more detail in Chapter 9, section 9.3.

7.2 RESTRICTIONS ON THE DEDUCTION OF INTEREST: THIN CAPITALIZATION AND EARNINGS-STRIPPING RULES

7.2.1 Introduction

When a resident corporation pays interest to nonresidents, the interest is usually deductible by the payer in computing income unless there are special rules to the contrary. The interest payments may be subject to withholding tax, but the rate of withholding tax may be substantially reduced or completely eliminated pursuant to an applicable tax treaty. The nonresident lender may or may not be subject to tax on the interest in its country of residence. If the nonresident lender is also the controlling shareholder of the resident corporation, the nonresident lender/shareholder will usually have a choice of financing its subsidiary with debt or equity and extract the profits of the subsidiary by receiving either dividends or interest.

Unlike interest, dividends paid by a resident corporation generally are not deductible. Accordingly, income earned by a resident corporation and distributed to its shareholders is subject to two levels of tax - corporate tax when the income is earned by the corporation, and shareholder tax when the income is distributed to the shareholders as a dividend. If the shareholder is a nonresident, the shareholder tax is usually imposed as a withholding tax.

In contrast, income earned by a resident corporation and distributed in the form of interest to a nonresident lender who is also a shareholder of the corporation is subject to only one level of tax. Because the interest is deductible by the corporation, usually the only source country tax is the withholding tax on the interest payment to the nonresident, and many countries have reduced or eliminated their withholding taxes on interest, either unilaterally or under their tax treaties. The advantage of paying interest to nonresident shareholders compared to paying dividends constitutes an inherent bias in favor of debt financing of resident corporations by nonresident investors. This bias is illustrated in the following example.

NCo, a nonresident corporation, owns all the shares of RCo, a resident corporation. RCo requires capital of one million to finance its business activities. To provide that capital, NCo can either subscribe for one million in additional shares of RCo, or it can loan RCo one million (or some combination of debt and equity). RCo earns income, before the payment of interest or dividends, of 100,000 and distributes its entire after-tax income as a dividend. The arm's-length interest rate payable on loans is 10 percent, and the applicable rates of withholding tax are 5 percent on dividends and 10 percent on interest. A comparison of the tax results of advancing funds by way of debt and equity are set out in Table 7.1.

Table 7.1 Relative Advantages of Debt and Equity Finance

	Debt	*Equity*
Corporate income before payment of interest or dividends	100,000	100,000
Deduction of interest	100,000	not applicable
Taxable income	nil	100,000
Corporate tax (40%)	Nil	40,000
Dividends	not applicable	60,000
Withholding tax (10%, 5%)	10,000	3,000
Total tax	10,000	43,000

As this example illustrates, financing a resident corporation with debt is considerably more effective in reducing the source country tax than financing with equity. The major reason is that interest is deductible, whereas dividends are not deductible. In addition, a resident corporation can repay a loan at any time without triggering tax, whereas it may not be able to repay equity investments (redeem shares or reduce capital) without triggering a taxable dividend.

In response to the bias in favor of debt compared with equity, several countries have adopted restrictions on the deduction of interest paid to nonresidents, or on the deduction of interest more generally. Under "thin capitalization" rules, the deduction for interest paid by a resident corporation to a nonresident controlling shareholder is denied to the extent that interest deductions claimed by the corporation are considered to be excessive. Under these rules, interest is considered to be excessive to the extent that the corporation's debt relative to its equity exceeds a fixed debt:equity ratio (often 1.5:1 or 2:1). The term "thin capitalization" is apt because the rules apply only when a corporation's equity capital is small in relation to its debt. Under earnings-stripping rules, interest is considered to be excessive if it exceeds a financial formula based on the earnings of the corporation (often 25-30 percent of earnings before the deduction of interest, taxes, depreciation and amortization, or "EBITDA").

The problem of deductible interest payments that erode a country's tax base relates primarily to payments to nonresidents. Interest payments to residents are not generally problematic because the residents receiving the payments are usually taxable on those payments. However, EU countries are prohibited from discriminating against residents of other EU countries, and the European Court of Justice has ruled that thin capitalization rules that are applicable only to interest payments to nonresidents are invalid insofar as they apply to residents of other EU countries. Consequently, some European countries have revised their thin capitalization rues so that they apply to all interest payments by resident corporations, including such payments to residents. Other countries have adopted earnings-stripping rules that apply to all interest payments by resident corporations irrespective of the residence of the recipient.

Some countries try to deal with the problem of excessive interest deductions by adopting statutory thin capitalization or earnings-stripping rules; others rely on

administrative guidelines or practices. Still others have applied transfer pricing or GAARs. The statutory rules of the various countries differ considerably. In some countries, thin capitalization rules are seen as specific transfer pricing rules for interest that are limited to interest payments to related or non-arm's-length parties. In other countries, the rules are targeted at interest payments that are viewed as disguised dividends: in other words, debt held by nonresident shareholders with a substantial interest in a resident corporation. Other countries consider the rules to be aimed at interest payments generally.

Although most countries' thin capitalization rules are targeted at certain interest payments - rather than all interest payments - to nonresidents, it must be recognized that all deductible interest payments by residents to nonresidents reduce or erode a country's tax base. Nevertheless, not all base-eroding payments are objectionable; many deductible payments by residents to nonresidents, including interest, represent legitimate income-earning expenses.

7.2.2 The Structural Features of Thin Capitalization and Earnings-Stripping Rules

Typically, thin capitalization and earnings-stripping rules have most of the following structural features.

Nonresident lenders. Thin capitalization and earnings-stripping rules generally apply only to interest paid to nonresidents who own a significant percentage of the shares of a resident corporation. The level of share ownership varies from a substantial interest in the shares (10-25 percent) to control (more than 50 percent of the shares) of the resident corporation. However, some countries, such as Australia, also apply their rules to resident corporations that use debt to finance foreign investment (so-called outbound thin capitalization rules). Moreover, as noted above, several European countries apply their rules to interest paid to both resident and nonresident lenders.

Domestic entities. The thin capitalization rules of most countries apply only to resident corporations. However, the stripping of profits through the payment of excessive interest to related persons may also arise with respect to partnerships and trusts and branches (PEs) of nonresident corporations. As a result, countries are increasingly extending the application of their thin capitalization rules to these entities.

Determination of excessive interest. Generally, thin capitalization and earnings-stripping rules apply only to certain "excessive" interest paid to nonresidents by resident corporations. Countries use a variety of different approaches to determine what constitutes excessive interest; there is no international consensus on this issue. The most common approach is the use of a fixed debt:equity ratio, under which only interest on a corporation's debt that is artificially large in relation to its equity - in effect, debt that is disguised equity - is not deductible. An alternative approach, recommended by the OECD for tax treaties, attempts to characterize debt and equity by reference to all the facts and circumstances, including the debt:equity ratio of the resident corporation. According to the OECD, this approach is consistent with the

arm's-length standard used for transfer pricing generally and avoids the inflexibility and arbitrariness of applying a fixed debt:equity ratio.

Under the earnings-stripping rules used by the United States (US) and several European countries, excessive interest is determined by reference to the relationship between a corporation's interest expenses and its income. A corporation is generally not entitled to deduct interest paid to certain nonresident shareholders to the extent that the interest exceeds a percentage of its income. The US approach is a combination of an earnings-stripping rule, under which interest in excess of 50 percent of a corporation's income is not deductible, and a thin capitalization rule, under which corporations that have a debt:equity ratio of no greater than 1.5:1 are not subject to the earnings-stripping rule. Under the German earnings-stripping rules, the deduction of interest by Germanresident corporations that are part of a corporate group is denied if the interest exceeds 30 percent of EBITDA, unless the German corporation is excessively leveraged compared to the group as a whole.

The OECD's BEPS Action 4: *Limiting Base Erosion Through Interest Payments and Other Financial Payments* recommends that countries should restrict interest deductions based on the net interest expense of the worldwide group as a percentage of the group's earnings (EBITDA). Thus, interest deductions of any resident corporation would be limited by reference to the earnings of the group as a whole rather than by an arbitrary debt:equity ratio. One of the difficulties with this approach is that it requires the tax authorities to have information about the interest expenses and earnings of the worldwide group.

One significant difference between the determination of excessive interest on the basis of earnings or a fixed debt:equity ratio is that earnings are sensitive to fluctuations in interest rates, whereas a fixed debt:equity rule is not. Thus, although a corporation may be better able to carry additional debt if interest rates decline, this fact is irrelevant under a fixed debt:equity ratio. However, under an earnings approach, taxpayers have an incentive to reduce their debt during periods of rising interest rates in order to avoid restrictions on the deduction of interest.

Computation of a debt:equity ratio. A debt:equity ratio for purposes of thin capitalization rules can be established either:

- as an arbitrary ratio, computed on a **consolidated** basis, ignoring any intercompany debt and equity; or
- by reference to the average debt:equity ratio for all resident corporations or all resident corporations engaged in a particular industrial or commercial sector.

Most countries seem to use an arbitrary debt:equity ratio of 1.5:1 to 3:1, sometimes with a higher ratio for financial institutions. The calculation of debt and equity as components of the ratio necessitates many subsidiary tax policy decisions. For example, should all debt held by nonresidents be taken into account, or just debt held by substantial nonresident shareholders? Should equity include contributed surplus or only share capital and retained earnings? How should hybrid securities such as preferred shares be classified? Should debt that is guaranteed by a nonresident shareholder be taken into account? Should a corporation's gross debt be reduced by

any cash on hand, especially since such cash may be earning interest income? A similar issue arises under an earnings-stripping rule: Should the limitation on interest deductions be based on a corporation's gross or net interest?

Consequences. The effect of the application of the thin capitalization or earnings-stripping rules is generally that excessive interest is not deductible. In some countries, this excessive interest is treated as a dividend. In other countries, excessive interest that is not deductible in one year can be carried forward and deducted in a subsequent year, assuming that it is not subject to the limitation on the deduction of interest in that year.

Tax authorities must be aware that their thin capitalization rules can be avoided if taxpayers channel their intercompany loans through back-to-back arrangements with international banks and other financial intermediaries. Assume, for example, that FCo, organized in Country F, lends money to B, an unrelated bank, which then relends the money to ACo, organized in Country A. FCo and ACo are members of an affiliated group of companies. The loan from B to ACo may not be subject to Country A's thin capitalization rules because it appears to be an arm's-length loan. Therefore, some countries' thin capitalization rules contain provisions that attempt to prevent the use of back-to-back loans and similar tax avoidance devices.

7.3 CFC RULES

7.3.1 Introduction

As noted in Chapter 3, section 3.3.1, one of the most effective ways for residents to avoid tax on their worldwide income is the use of CFCs and other legal entities to earn foreign source income. Domestic tax on foreign source income can easily be deferred or avoided completely by establishing a foreign corporation or other legal entity, such as a trust, to earn the income. Because the foreign corporation or trust is generally considered to be a separate taxable entity and not resident in the country where its controlling shareholders or beneficiaries are resident, those shareholders or beneficiaries are not taxable when the income is earned by the foreign corporation or trust.

When distributions from the corporation or trust are paid, the shareholders or beneficiaries may be taxable by the residence country. However, many countries exempt dividends from foreign corporations from residence country tax if the dividends are received on shares owned by a resident corporation with a substantial interest in the foreign corporation. Even if the distributions are taxable, the residence country tax is postponed until distributions are received, which may be several years after the foreign entity earns the income. Thus, earning income through a foreign entity may result in the deferral or complete avoidance of residence country tax. The benefit is greatest when the foreign tax on the income of the foreign corporation or trust is low or nil. Therefore, the problem arises primarily from the establishment of CFCs or trusts in tax havens.

The problem of tax avoidance and deferral through the use of controlled foreign entities is most pronounced with respect to passive investment income because such

income can be easily diverted to or accumulated in an offshore entity in a tax haven. For example, assume that a corporation resident in Country A earns interest income of 1,000 from bonds and the tax rate in Country A is 40 percent. If the corporation establishes a wholly owned subsidiary in a tax haven that does not impose tax, it can defer tax of 400 by transferring the bonds to the subsidiary. The interest income derived by the subsidiary may not be subject to Country A's withholding tax, either because the interest is not sourced in Country A or because the interest is exempt from withholding tax. However, even if the interest is subject to Country A's withholding tax, the corporation can defer Country A's tax to the extent of the difference between the corporate tax rate and the withholding tax rate (which may be substantial). The tax benefit from the transfer of the bonds to the subsidiary will be even greater if Country A provides a participation exemption for dividends received from foreign corporations.

Where a residence country imposes tax on distributions from foreign corporations and other entities, residence country tax is deferred, but not avoided entirely. When a foreign subsidiary distributes dividends to its resident parent corporation or when the parent corporation disposes of its shares in the foreign subsidiary, the residence country will presumably tax the distribution or gain. Therefore, the benefit of deferral in any particular case depends on the difference between the domestic and foreign tax rates, the rate of return on the deferred taxes, and the period of deferral. Under standard present value calculations, indefinite deferral is nearly equivalent to exemption.

Several countries have adopted detailed statutory rules to prevent or restrict the use of CFCs to defer or avoid domestic tax. The US was the first country to adopt CFC rules (Subpart F) in 1962; the rules were based on similar rules (the foreign personal holding company rules), adopted in 1937, that were targeted at the use of foreign corporations by individuals. The adoption of the Subpart F rules was very controversial. The rules that were finally enacted represented a compromise between the original proposal to eliminate deferral for all income of CFCs and the arguments of US-based multinationals that deferral should be eliminated only with respect to clearly passive income. Subpart F remains controversial today. For many years, US multinationals have argued that the Subpart F rules are broader and tougher than the CFC rules of other countries and that they put US multinationals at a competitive disadvantage. In January 2001, the US Treasury issued a report on Subpart F (*The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, December 2000), which concluded that the basic policy of Subpart F was appropriate and there was no convincing evidence that the international competitiveness of US multinationals was adversely affected by the rules.

Since the US adopted Subpart F in 1962, several other capital-exporting countries have enacted CFC rules to protect their tax base. As of 2015, over thirty countries had enacted CFC rules. This is a well-established trend that will likely continue.

The basic pattern of CFC legislation is similar in all countries. Resident shareholders that control, or have a substantial interest in, a foreign corporation established in a no-tax or low-tax country are subject to residence country tax currently on their proportionate share of all or some of the income of the foreign corporation, whether or not the income is actually distributed to them. If a foreign corporation is engaged in

legitimate commercial activities offshore, however, the CFC rules do not generally apply to the income generated by those activities. For example, assume that ACo, a resident of Country A, owns all the shares of a CFC resident in a low-tax country. The CFC earns passive income of 1,000 and pays tax of 100 on that income to its country of residence. The CFC does not distribute any of its after-tax income to ACo. If Country A has CFC rules, ACo would be subject to tax by Country A on the CFC's income of 1,000 (despite the fact that ACo has not received any distribution of that income from the CFC) and would receive credit for the tax paid by the CFC of 100. Thus, if Country A imposes tax at a rate of 40 percent, ACo would pay tax of 300 (400 less a foreign tax credit of 100), which is exactly the amount of tax that ACo would have paid if it had earned the income directly.

The basic structure of CFC legislation reflects two competing policies. First, there is a desire to prevent tax avoidance and to advance the traditional goals of fairness and economic efficiency discussed in Chapter 1, section 1.3. At the same time, countries generally do not want to interfere unreasonably in the ability of resident corporations to compete in foreign markets. In every country with CFC measures, there is a balancing of these two policies, although the balance is struck differently in every country. Other than Brazil, no country eliminates entirely the benefits from the use of CFCs, and most countries limit the application of their CFC rules to CFCs established in low-tax countries and to passive income earned by CFCs. In contrast, the Brazilian CFC rules apply to all of the income, active and passive, of all CFCs in which Brazilian residents own 20 percent or more of the shares, irrespective of the country in which the CFCs are resident. The original New Zealand CFC rules also differed markedly from other countries' CFC rules and came close to eliminating deferral entirely; they applied to all the income, active and passive, of all CFCs controlled by New Zealand residents, except those established in seven listed countries. However, the New Zealand CFC rules were revised in 2010 to exclude active business income from the application of the CFC rules.

7.3.2 Structural Features of CFC Rules

Although CFC rules vary considerably, several fundamental structural aspects of the rules are the same in most countries. These aspects of the taxation of CFCs are discussed below.

7.3.2.1 Definition of a CFC

With a few exceptions, countries restrict the scope of their CFC rules to income derived by entities (1) that are nonresident, (2) that are corporations or similar entitles taxed separately from their owners, and (3) that are controlled by domestic shareholders or in which domestic shareholders have a substantial interest. Entities (such as partnerships) that are taxable on a conduit or flow-through basis are not within the scope of the CFC rules if the resident partners of a foreign partnership are subject to residence country tax on their share of the partnership's income. The status of an entity as a

nonresident is established in accordance with the residence country's normal residence rules for legal entities (place of incorporation or place of management, or both). The residence rules for corporations and legal entities are discussed in Chapter 2, section 2.2.2.

Although it may seem strange, some countries, such as France, apply their CFC rules to foreign branches or PEs. The extension of CFC rules to foreign branches or PEs is necessary where a country exempts income earned through a foreign branch or PE and the exempt income includes passive income that, if earned by a CFC, would be subject to the country's CFC rules. The application of the CFC rules to foreign branches or PEs is not necessary if the exemption for income earned through foreign branches or PEs is limited to active business income (i.e., income that would not be subject to the CFC rules if it were earned by a CFC).

Not surprisingly, given the title of "controlled foreign corporation" rules, most CFC legislation applies only to foreign corporations that are *controlled* by certain domestic shareholders. In general, control means the ownership of more than 50 percent of the outstanding voting shares. Some countries extend the concept of control to include ownership of shares having a value equal to more than 50 percent of the total value of the outstanding shares of the corporation. Other countries have rules that presume residents to control a foreign corporation in certain circumstances even if they own less than 50 percent of the voting shares. For example, the Australian and New Zealand CFC rules deem a resident to control a foreign corporation if the resident owns 40 percent or more of the voting shares of the foreign corporation and no nonresident person has voting control of the corporation.

Only a few countries have adopted a de facto control test as a supplement to the basic de jure control test. Under a de facto control test, a resident taxpayer is considered to control a foreign corporation if, based on all the facts and circumstances, the taxpayer has the means to control the affairs of the corporation even where it does not have voting control. For example, a taxpayer that owns 20 percent of the shares of a corporation may have de facto control of the corporation if the rest of the shares are widely held. A de facto control test involves considerable uncertainty for taxpayers and is also difficult for the tax authorities to apply.

The rationale for the control requirement is fairness. It would be unfair to tax resident shareholders on the undistributed income of a foreign corporation if they do not have sufficient legal or actual power or influence over the foreign corporation to determine the activities it engages in (i.e., whether it is subject to the CFC rules) and to require it to distribute its income.

A few countries, such as Brazil, Denmark, and Portugal, have rejected the complexity and the limitations of a control test. They apply their CFC rules to foreign corporations in which residents have a substantial (20 percent in the case of Brazil; 25 percent for Portugal and Denmark) ownership interest. Until 2004, France applied its CFC rules to French residents owning 10 percent or more of the shares of a CFC.

Control for purposes of CFC rules includes indirect control. The CFC rules cannot be avoided by having the shares of a tax haven corporation owned by another foreign corporation that is controlled by residents. For example, if a resident owns 60 percent of the voting shares of ACo, which in turn owns more than 50 percent of the voting

shares of a second foreign corporation, BCo, BCo is considered to be a CFC of the resident. Indirect control is usually determined by multiplying a taxpayer's interest in one corporation by the corporation's interest in other corporations, and so on. For example, if ACo owns 40 percent of the shares of BCo and BCo owns 30 percent of the shares of CCo, ACo is considered to own 12 percent of CCo. However, if one corporation controls another corporation, that corporation should be considered to own all the shares of any other corporations owned by it. For example, if ACo owns 51 percent of the shares of BCo and BCo owns 51 percent of the shares of CCo, ACo would be considered to own all the shares of CCo owned by BCo, rather than just 26.01 percent (51 percent × 51 percent). Therefore, ACo would be considered to control BCo and CCo (and any corporations controlled by CCo).

Most countries also have constructive ownership rules to prevent taxpayers from avoiding the CFC rules by fragmenting the ownership of shares among related persons. For example, if one resident corporation owns 40 percent and another resident corporation owns 20 percent of the voting shares of a foreign corporation, the foreign corporation will be a CFC of both resident corporations if they are related because, for example, they are both wholly owned subsidiaries of another resident corporation. Whether persons are related for this purpose is determined under the country's domestic law.

In some countries, control must be concentrated in a small number of resident shareholders in order for the CFC rules to apply. For example, Australia, Canada, and New Zealand require that control of a foreign corporation must be concentrated in five or fewer resident shareholders. Under the US Subpart F rules, only US shareholders owning at least 10 percent of the shares of the foreign corporation are counted in determining whether the foreign corporation is a CFC. In other countries, such as Norway and Germany, even foreign corporations that are widely held by resident shareholders are considered to be CFCs.

The concentrated-ownership requirement is related to the rationale for a control test. Whenever the shares of a foreign corporation are widely held by resident shareholders, those shareholders are unlikely to be able to exercise sufficient power over the corporation to determine its income-earning activities or require it to make distributions. A concentrated-ownership requirement requires constructive ownership rules and perhaps anti-avoidance rules.

7.3.2.2 Designated Jurisdiction or Global Approach

The primary focus of CFC rules is tax haven entities. As a result, the CFC rules of most countries are limited to CFCs located in countries that are defined and designated to be tax havens (the "**designated jurisdiction approach**"). However, a few countries, such as Brazil, Canada, and the US, apply their CFC rules to certain specified categories of income earned or received by a CFC, regardless of whether the CFC is resident in a tax haven or a high-tax country (the "**global approach**").

Under the designated jurisdiction approach, the residence of a foreign corporation in a designated tax haven is crucial to the application of the CFC rules. Because all

foreign corporations established in countries that are not designated as tax havens are exempt from the CFC rules, the compliance and administrative burden of the rules is reduced compared to the global approach. Under the global approach, the residence of the foreign corporation is irrelevant. The theory behind this approach is that all countries, even generally high-tax countries, have aspects of their tax system that permit the earning of preferentially or low-taxed income. Under the designated jurisdiction approach, the legislation usually provides a general definition of what constitutes a tax haven; the tax authorities then supplement that definition by issuing a list of countries that are regarded as tax haven countries, or that are not regarded as tax havens. However, some countries simply use a list of tax haven or non-tax haven countries without any statutory definition of what constitutes a tax haven.

The general definition of a tax haven is invariably based on a comparison of the taxes levied in the foreign country and in the residence country. If the foreign country actually levies taxes at approximately the same rates as the residence country, the foreign country should not be considered to be a tax haven because it cannot be used to defer or avoid a significant amount of residence country tax. The comparison of domestic and foreign tax rates can be based on:

- nominal tax rates;
- effective tax rates; or
- the actual foreign tax paid by a particular CFC.

The use of nominal tax rates to identify tax havens is problematic because it ignores generous deductions, exemptions, credits, or allowances that may be afforded by a foreign country. The use of effective tax rates is also problematic, because effective tax rates are difficult to determine and would have to be determined annually for every country in which a CFC of a resident corporation is resident. Moreover, just because a country has high effective tax rates does not mean that a particular CFC resident in that country may not be subject to low foreign taxes. A few countries use the effective-tax-rate approach. Most countries, however, focus on the actual foreign tax paid by a CFC.

The comparison of the actual foreign tax paid by a CFC and the notional domestic tax that the CFC would have paid as a resident corporation is the theoretically correct approach because it focuses on the situation of each particular CFC. However, this approach imposes onerous compliance burdens on taxpayers because the income of a CFC must be recomputed in accordance with residence country rules in order to determine the amount of the notional domestic tax.

The specific relationship between the foreign tax and the residence country tax varies considerably. Some countries define a tax haven as a country whose tax rate is less than 55 percent (Sweden), 60 percent (Finland), 66 2/3 percent (France and Norway) or 75 percent (Spain and the United Kingdom (UK)) of the residence country rate. Other countries define a tax haven simply by reference to the foreign rate. For example, Germany and Japan define a tax haven as a country that levies tax of less than 25 percent; Korea uses 15 percent. Even a small difference between the foreign and domestic tax rates may be sufficient to induce resident taxpayers to shift passive income (which is easily shifted) to a CFC in a foreign country.

As a result of the difficulties that arise in defining a tax haven by comparing its tax rate to the domestic tax rate - in particular, uncertainty for both taxpayers and tax authorities - most countries that use a designated jurisdiction approach have supplemented their definition of a tax haven with a list of tax haven countries, or non-tax haven countries, or both. The list may be either legislative (included in the legislation making up the CFC rules) or administrative (issued by the tax authorities). Such a list is intended to provide taxpayers and tax officials with concrete guidance. The lists vary widely: some are determinative (legally binding) of a country's status as a tax haven or a non-tax haven, while others merely establish rebuttable presumptions. The more sophisticated lists recognize that a country that generally is a high-tax country may nevertheless impose little or no tax on certain types of income or entities. Consequently, such countries may be placed on a non-tax haven list, subject to certain exceptions for preferentially taxed income or entities. As a result, CFCs that do not qualify for those countries' low-tax regimes will be exempt from the CFC rules.

The global approach is more precise than the designated jurisdiction approach. As mentioned above, under the global approach, the country of residence of the CFC is irrelevant and therefore, every transaction engaged in by all CFCs of all resident taxpayers must be examined in order to determine the nature of the income from the transaction. If the corporation has **"tainted" income**, as discussed below, the income is attributed to the domestic shareholders of the corporation and is subject to tax in their hands, with a credit for any foreign taxes on the income. Consequently, the CFC rules potentially apply even to CFCs in high-tax countries if they earn tainted income. In contrast, although the designated jurisdiction approach is not as precise, it minimizes the compliance and administrative burdens of the CFC rules.

7.3.2.3 Definition and Computation of Attributable Income

Some countries employ what may be called an **entity approach** in taxing the income of a CFC to its domestic shareholders. Under this approach, the CFC rules usually provide an exemption for certain CFCs that are engaged primarily in genuine business activities. This exemption is discussed in section 7.3.2.4 below. If a CFC does not qualify for any of the exemptions, all its income is attributable to its domestic shareholders. If, however, the CFC qualifies for the exemption, none of its income, even its passive income, is attributable to its domestic shareholders. This all-or-nothing result is the essential characteristic of the entity approach.

In contrast, other countries follow a **transactional approach**, under which only certain types of income (referred to as "tainted income") derived by a CFC are subject to attribution. Under a transactional approach, each transaction entered into by a CFC must be analyzed to determine whether it produces tainted or other income and, for this purpose, tainted income is determined by applying residence country tax rules. Although the entity approach is less precise than the transactional approach, it minimizes the compliance and administrative burden of CFC rules. Some countries use a hybrid approach that combines elements of the transactional and entity approaches. For example, some countries, such as Australia, New Zealand, and the US, use a

transactional approach but provide an exemption for CFCs whose tainted income is less than a specified percentage of its total income.

Tainted income usually consists of passive investment income and **base company income**. Passive income consists of dividends, interest, rents, royalties, and capital gains. All countries with CFC rules consider passive income to be tainted income, although they define passive income differently. Perhaps the most difficult issue in defining passive income for purposes of CFC rules is identifying situations in which passive income should be classified as active business income. For example, interest earned by a genuine financial institution is generally considered to be active business income and therefore exempt from CFC rules. Similar issues arise with respect to rents and royalties.

The term "base company income" is used to refer to any income, other than passive income, that is considered to be tainted income for purposes of CFC rules. The definition of base company income is often quite complex and the scope of the definition for purposes of various countries' CFC rules varies considerably.

In general, there are three major components of base company income:

(1) *Income derived by a CFC from the country in which its controlling shareholders are resident.* If such income is not taxable by the residence country, that country's tax base is eroded. Many countries consider the erosion of their tax base by a CFC in this manner to be inappropriate, especially since in many situations the income could be earned by the parent of the CFC directly.

(2) *Income derived by a CFC from transactions with related parties.* The treatment of income from related-party transactions as tainted income is usually intended to bolster a country's transfer pricing rules. Transfer pricing rules are intended to prevent the diversion of income to related foreign corporations through the non-arm's-length pricing of sales, services, and other transactions. (See Chapter 6.) These rules are notoriously difficult to enforce. By treating such income as tainted income for purposes of CFC rules, countries can avoid the necessity of applying their transfer pricing rules.

(3) *Income derived by a CFC from transactions outside the country in which it is resident.* The rationale for treating income from transactions outside the CFC's local market as tainted income relates to considerations of international competitiveness. Income from local market transactions is usually exempt because the current imposition of residence country tax on such income of a CFC would adversely affect the ability of the multinational enterprise of which the CFC is part to compete in that country. Where, however, the CFC derives income outside its local market, the deferral of residence country tax is not necessary for the CFC to compete in its local market. Moreover, where a CFC does business in its country of residence, there are probably good commercial reasons for it to be established there.

These three categories of base company income are not mutually exclusive. Thus, for example, some countries limit the definition of base company income to income derived from related-party transactions outside a CFC's country of residence or

to income from the country in which the controlling shareholders are resident as a result of related-party transactions.

One key aspect of the definition of tainted income concerns income from intercompany transactions between CFCs. For example, significant tax savings can be achieved if a CFC that is resident in a high-tax country pays interest, royalties, or other deductible amounts to a CFC resident in a low-tax country. In the absence of special rules, interest, royalties, and other amounts received by a CFC would likely be considered to be passive income subject to the CFC rules. However, many countries have adopted special rules to exclude such intercompany payments from the scope of tainted income. Thus, in general, multinational enterprises can establish group finance companies or holding companies for intellectual property in order to reduce foreign taxes without becoming subject to the CFC rules.

Any tainted income of a CFC that is attributable to its domestic shareholders should be computed in accordance with domestic tax rules and in domestic currency. This obligation presents many difficulties because of differences between foreign and domestic tax laws. Generally, a CFC is not allowed to consolidate its profits and losses with the profits and losses of other CFCs of the same domestic shareholders.

7.3.2.4 Nature and Scope of Exemptions

Countries may provide a variety of exemptions that limit the scope of their CFC rules. The most important of these exemptions are described below. The exemptions vary depending on whether a country uses an entity or transactional approach, as described above. All countries with CFC legislation provide at least some of these exemptions.

Exemption for genuine business activities or active business income. An exemption is usually granted, expressly or implicitly, for CFCs engaged primarily or exclusively in genuine business activities or for active business income earned by CFCs. Countries that use a transactional approach, as described above, tax only the tainted income of a CFC. Inherent in this approach is the exemption of active business income, since such income is not considered to be tainted income. Other countries use an entity approach, under which each CFC is tested and either all or none of its income is attributed to its domestic shareholders. Under the entity approach, an exemption is invariably provided for CFCs engaged primarily or almost exclusively in genuine business activities. This exemption is generally available only if: (1) the CFC is engaged in certain defined active businesses or is not engaged in investment activities; (2) it has a substantial presence in the foreign country; and (3) less than a certain percentage (usually 50 percent) of its income is tainted income (generally passive income and base company income).

Only the CFC rules of Sweden and Brazil do not distinguish between active business income and other income. Under their CFC rules, all the income of a CFC that is not exempt is attributable to its domestic shareholders. However, Sweden provides broad exemptions from the CFC rules; virtually all CFCs established in countries with which Sweden has a tax treaty, as well as other high-tax countries, are exempt.

Distribution exemption. To the extent that a CFC distributes dividends out of its current profits to its resident shareholders that are subject to residence country tax, there is arguably no need to apply the CFC rules, since residence country tax is neither avoided nor deferred. Despite the theoretical justification for a distribution exemption, no country currently provides such an exemption from the CFC rules. Part of the reason for the absence of a distribution exemption is that many countries exempt dividends from CFCs; another reason is that distribution exemptions are surprisingly complex and some countries that had initially adopted such exemptions later eliminated them.

De minimis exemption. A *de minimis* exemption is frequently granted for CFCs whose income (or tainted income) does not exceed a minimum amount. *De minimis* exemptions vary widely, and several countries do not provide any such exemption. The Canadian exemption is available only if the CFC's tainted income is CAN 5,000 (approximately USD 3,750 as of late 2015 - a meaninglessly small amount) or less. Other countries provide sizeable *de minimis* exemptions, although they are difficult to justify on tax policy grounds. *De minimis* exemptions appear to be largely motivated by political considerations in order to allay fears that CFC rules will impose significant compliance costs on taxpayers in respect of relatively small amounts of income subject to tax.

Other exemptions. A few countries provide an exemption for CFCs that are not used for the purpose of avoiding or reducing tax (a "motive" exemption). Although a motive exemption is perhaps consistent with the anti-avoidance purpose of CFC legislation, it gives the tax authorities considerable discretion. It may be a simple way of limiting the scope of the rules without the legislative complexity necessitated by more specific exceptions.

The UK provides an exemption for CFCs that earn low profit margins.

7.3.2.5 Resident Taxpayers Subject to Tax

In most countries, both individual and corporate shareholders are subject to tax under the CFC rules; in a few countries, the rules apply only to resident corporations. There does not appear to be any good reason why the rules should not apply to individuals.

In most countries, the undistributed income of a CFC is attributed to resident shareholders who own shares in the corporation at the end of its taxation year. This approach may appear to be unfair because it taxes shareholders on their pro rata share of the CFC's income for the entire year despite the possibility that they may have owned their shares for only part of the year. However, this approach is much simpler, although less precise, than determining a taxpayer's share of the income of a CFC for part of a year. In addition, once the end-of-the-year rule is well understood, persons acquiring shares of a CFC can be expected to take the rule into account in setting the purchase price of the shares.

In most countries, resident shareholders of a CFC are not taxable on their share of the undistributed income of the foreign corporation unless they meet a minimum

share ownership requirement (usually 10 percent). The reason for this exemption for shareholders with small investments in a CFC is that they may not have sufficient influence over the foreign corporation to require it to distribute its income or obtain access to the information necessary to compute their share of the income. Nevertheless, these small shareholders may be counted in determining whether a foreign corporation is controlled by resident shareholders.

7.3.2.6 Relief Provisions

Typically, countries provide some relief from double taxation that may otherwise occur from the operation of their CFC rules. Because the basic taxing mechanism under CFC rules is to tax the resident shareholders of a CFC on their share of its undistributed income, the possibility of double taxation arises where the CFC's income is subject to foreign tax and where a shareholder receives dividends from a CFC or disposes of its shares in the corporation. Most countries provide relief for foreign taxes and subsequent dividends out of previously taxed income of a CFC, but few countries provide relief for capital gains from the disposal of shares of a CFC that reflect previously taxed income of the CFC. These double taxation issues are illustrated in the following example.

PCo, a resident of Country P, owns all the shares of SCo, a resident of Country S. In 2016, SCo earns passive income of 1,000 in Country S and pays tax of 100 to Country S on its income. Under Country P's CFC rules, PCo is taxable on SCo's income of 1,000 at a rate of 40 percent (or 400) and qualifies for a foreign tax credit of 100 for the tax paid by SCo to Country S of 100. In 2018, SCo pays a dividend to PCo of 900. Since PCo has already been taxed on the income out of which the dividend was paid, the dividend should be exempt from Country P tax if it is otherwise taxable under the laws of Country P. If Country S imposes withholding tax of 10 percent on the dividend, Country P should also provide relief for that withholding tax, perhaps by allowing it to be carried back and claimed as a foreign tax credit in 2016 or by allowing it to be claimed against any tax on CFC income for 2018 or future years.

If PCo sells the shares of SCo in 2018 without receiving a dividend, the proceeds of sale will presumably reflect SCo's after-tax income for 2016 of 900. Since PCo has already paid tax to Country P on that amount, it should not be required to pay tax on the capital gain realized on the sale of the shares of SCo. If no relief is provided by Country P in this situation, PCo is likely to consider having SCo pay a dividend of 900 (which will probably be exempt from tax by Country P, as explained above) to reduce the capital gain on the sale of the shares.

Losses of a CFC are not generally attributable to its resident shareholders. Most countries permit such losses to be carried forward and deducted in computing the attributable income of the CFC in future years.

Most countries' CFC rules do not provide specific relief from double taxation resulting from the application of the CFC rules of two or more countries. For example, assume that ACo, resident in Country A, owns all the shares of BCo, resident in Country

B. BCo owns all the shares of a corporation that is established in a tax haven and earns passive income. If Country A and Country B both have CFC rules, the passive income of the tax haven corporation may be subject to tax to ACo by Country A and to BCo by Country B. Although it may appear that Country A should give credit for the tax levied by Country B pursuant to its CFC rules, Country A may take the position that the passive income of the tax haven corporation was shifted from Country A and should be taxable in Country A. Some countries provide specific relief, by way of deduction or credit, for foreign taxes levied pursuant to another country's CFC rules. Other countries provide no relief, although relief might be available under the mutual agreement procedure of an applicable tax treaty. This double-tax problem is becoming more serious as more countries adopt CFC rules.

7.3.3 Tax Treaties and CFC Rules

The relationship between tax treaties and CFC rules is controversial. In Finland, France, Japan, Sweden, and the UK taxpayers have challenged the application of CFC rules to foreign subsidiaries as a violation of an applicable tax treaty. The taxpayers have argued that the business profits article of the typical tax treaty (Article 7 of the OECD and UN Model Treaties) provides that a country (the country with CFC rules) cannot impose tax on the business profits of a corporation resident in the other country (even if controlled by residents of the first country) except to the extent that the corporation has a PE in the first country and the profits are attributable to the PE. In response, the tax authorities have argued that under CFC rules, tax is imposed on the resident shareholders of the foreign corporation, not the CFC, and nothing in a tax treaty prevents a country from taxing its own residents.

The strength of these arguments varies depending on the particular country's CFC rules and the specific provision of the treaty. As noted above, most countries' CFC rules do not apply to active business income; moreover, several countries do not apply their CFC rules to CFCs resident in treaty countries. As a result, the potential conflict between tax treaties and CFC rules is limited. The cases have been decided uniformly in favor of the tax authorities, except in France, where the highest French court held that Article 7 of the France-Switzerland treaty prevented the application of the French CFC rules to a Swiss subsidiary of a French corporation.

The Commentary on Article 1 of the OECD Model Treaty was revised in 2003 to clarify that, according to the OECD, there is no conflict between CFC rules and tax treaties; therefore, tax treaties do not prevent the application of CFC rules. Further, the revisions to the Commentary clarified that it is not necessary for countries with CFC rules to put an explicit provision in their treaties allowing the application of CFC rules. A few countries - Belgium, Luxembourg, the Netherlands, and Switzerland - have registered their disagreement with this aspect of the Commentary. The Commentary does caution countries not to apply their CFC rules to companies resident in treaty countries that are subject to tax in those countries comparable to the tax imposed by the resident country.

7.4 NONRESIDENT TRUSTS

Trusts are legal relationships under which the legal ownership and management of property is separated from its beneficial ownership. Trusts originated under English law as part of the common law and are recognized under the laws of most common law countries. Some civil law countries have adopted legislation to allow the establishment of trusts or trust-like relationships. Typically, a trust involves a **settlor** (the person who establishes the trust and transfers (settles) property to the trust) and a **trustee** (the person who has legal ownership and management of the property for the benefit of one or more **beneficiaries** (the persons who are the beneficial owners of the property)). A trust is a particularly flexible arrangement because the settlor of the trust may also be a trustee and a beneficiary. Trusts may be either discretionary or nondiscretionary. Under a nondiscretionary trust, the interests of the beneficiaries are fixed and cannot be altered without the amendment of the trust. In contrast, under a discretionary trust, the trustee has discretion with respect to the amount of income or capital payable to any particular beneficiary.

The flexibility of trusts makes them difficult to tax, and the difficulty is magnified with respect to nonresident trusts. In many countries that recognize trusts, they are taxed as entities, at least to the extent that they accumulate their income.

Beneficiaries are generally taxable on trust income that is distributed to them, but not on distributions of the capital of the trust, which generally includes the after-tax income of the trust (in other words, the income earned or received by a trust in a year is usually added to the trust's capital if it is not distributed in the year).

If a resident of Country A establishes a trust in a tax haven (and many tax havens, especially former UK colonies, have adopted flexible trust legislation to facilitate this practice) for the benefit of family members who are also resident in Country A, in the absence of special rules, Country A may be unable to tax the income of the trust unless the beneficiaries receive current distributions out of the trust's income. The trust itself is not a resident of Country A and therefore is not taxable by Country A except to the extent that it derives income from Country A. In most cases, any income earned by the trust in a year will be accumulated in the trust and distributed to the beneficiaries only in subsequent years as tax-free capital distributions or after they have ceased to be resident in Country A.

To prevent this type of tax avoidance, some countries have adopted special rules that attempt to impose tax if a resident transfers property to a nonresident trust with resident beneficiaries. Taxpayers may attempt to avoid these rules by establishing foreign trusts with a recognized international charity as the only named beneficiary, but with a power in the trustee or a protector (usually a trusted friend or adviser who is a nonresident) to add new beneficiaries to the trust at any time. Alternatively, some tax havens allow the establishment of purpose trusts, which do not require any named beneficiaries. In response, some countries have extended their nonresident trust rules to tax the resident settlor (any resident who transfers property to a nonresident trust) on the income of the trust. This measure may be considered to be draconian because legally the settlor has no right to obtain any funds from the trust. However, it is

intended to stop residents from transferring funds to nonresident trusts in the first place, in recognition of the difficulty that countries have in taxing the income of such trusts, either by taxing the trust or its resident beneficiaries.

7.5 FOREIGN INVESTMENT FUNDS

As discussed in section 7.3.2.1 above, CFC legislation generally applies only to foreign corporations that are controlled by resident shareholders, and in some countries, only to foreign corporations that are controlled by a small group of resident shareholders. Moreover, the CFC rules of several countries apply only to resident shareholders that own a minimum percentage (usually 5-10 percent) of the shares of the foreign corporation. As a result, it is relatively easy for foreign investment companies, mutual funds, or unit trusts to be established in low-tax countries without being subject to the CFC rules. Such foreign investment funds allow resident taxpayers to defer domestic tax on their passive investment income. Foreign investment funds may also permit taxpayers to convert what would otherwise be ordinary income into capital gains on the disposition of interests in the fund.

Several countries have enacted detailed legislation to prevent the deferral of domestic tax through the use of foreign investment funds. For some countries, the purpose of these rules is to prevent the avoidance of CFC legislation. For some other countries, the foreign investment fund rules have a much broader purpose: they are intended to eliminate the benefit of deferral for all investments in passive foreign corporations and other entities that are not subject to the CFC rules.

When thinking about foreign investment fund rules, it is useful to compare the tax consequences of three alternative investments: (1) an investment in a foreign investment fund; (2) an investment in a domestic investment fund; and (3) a direct foreign investment (e.g., purchase of a foreign bond or rental real property located offshore). The essential difference between the tax consequences for a resident investing in a domestic investment fund as compared to a foreign investment fund is that residence country tax is deferred with respect to a foreign fund until the resident receives distributions or disposes of the interest in the fund. In contrast, domestic tax is customarily imposed on the income derived by a domestic investment fund.

The benefit of an investment in a foreign investment fund compared to a direct foreign investment is that the income from the fund can be effectively converted into capital gains if the fund accumulates its income. This conversion of investment income into capital gains may also occur with respect to investments in shares of resident corporations. However, resident corporations are subject to current corporate tax in the residence country on their income, whereas foreign corporations are not.

As a result, the tax systems of many countries contain an incentive for resident individuals to invest in foreign corporations as compared to resident corporations whenever (1) foreign taxes on the foreign corporation's income are less than the domestic taxes on the equivalent amount of income of a resident corporation, and (2) the foreign corporation accumulates at least part of its income. The incentive is greatest where the foreign corporation is based in a tax haven and accumulates all of its income.

Countries use several different approaches to deal with investments in foreign investment funds, and in certain circumstances, some countries use more than one method. The methods are described briefly below.

CFC rules. In some countries, such as Germany, the foreign investment fund rules form part of the CFC rules. The CFC rules apply to small investors in foreign corporations and other entities controlled by residents if the entities earn primarily passive income.

Purpose test. Some countries, such as Canada, have a purpose-based specific anti-avoidance rule to deal with residents that own interests in a foreign investment fund. Thus, residents who hold an interest in a foreign investment fund are taxable on imputed income if one of the primary purposes for the acquisition or holding of the interest in the fund is to avoid tax.

Mark-to-market method. A mark-to-market method is essentially an accrual-based capital gains tax under which any increase or decrease in the value of a resident taxpayer's interest in a foreign fund must be included in computing the taxpayer's income for each year. For example, if a taxpayer's interest in a foreign investment fund has a value of 300 at the start of a year and 500 at the end of the year, the taxpayer would be subject to tax on a gain of 200. If the value of the interest declined to 200 at the end of the following year, the taxpayer would have a loss of 300.

The mark-to-market method is easy to apply if the foreign investment fund is actively traded on a stock exchange or if the fund provides information on the current value of interests in the fund (usually for the purpose of redeeming investors' interests). In other circumstances, it may be quite difficult to value interests in a foreign investment fund except when they are sold.

Imputed income approach. Under an imputed income or deemed rate of return approach, the resident taxpayer is considered to have earned income on the amount invested in the offshore fund at a specified rate, irrespective of the actual income earned by the fund. For example, if the specified rate of return is 10 percent, an individual who invests 10,000 in the fund would be taxable on deemed income of 1,000. Any deemed income for a year would then be added to the cost of the interest in the fund. Thus, assuming no distributions from the fund are made, the individual would be taxable on deemed income of 1,100 (10 percent of 11,000) for the following year.

The advantage of the imputed income method is that it is simple to apply and minimizes the compliance burden on taxpayers and the administrative burden on the tax authorities because it is unnecessary for them to obtain specific information about the income of the foreign investment fund. However, the imputed income method may result in the under- or over-taxation of investors.

Deemed distribution approach. Under this approach, resident shareholders are subject to tax on their pro rata share of the income of the foreign fund regardless of whether the income of the fund is distributed. This approach is the same as the method of taxation under CFC rules: it requires taxpayers to have access to sufficient information in order to compute their share of the foreign investment fund's income. As a result, it is sometimes limited to taxpayers who own a substantial interest in the offshore entity.

Deferral charge approach. Under this approach, residence country tax is not imposed until distributions are received or gains are realized. However, at that time an interest charge is imposed to eliminate the benefits of deferral that the taxpayer has enjoyed.

Most countries that have foreign investment fund rules generally apply their rules only to foreign entities that earn primarily passive income or whose assets consist primarily of passive assets such as marketable securities. Exemptions are often provided for foreign entities that are principally engaged in an active business or that distribute virtually all of their income currently. The distinction between active and passive income or assets is a difficult one to make in a satisfactory manner and usually requires complex rules. Most countries provide double-tax relief for foreign taxes, actual distributions, and capital gains on the disposition of ownership rights in the fund. These relief mechanisms are similar to those provided in comparable circumstances for income derived through CFCs (see section 7.3.2.6 above).

CHAPTER 8
An Introduction to Tax Treaties

8.1 INTRODUCTION

Bilateral tax treaties are an important feature of the international tax landscape that serve as a bridge between the tax systems of the contracting states. Over 3,000 bilateral income tax treaties are currently in effect, and the number is growing. Most bilateral tax treaties are based in large part on the OECD Model Treaty or the UN Model Treaty. The UN Model Treaty is substantially similar to the OECD Model Treaty, but includes some additional and different provisions that permit source countries to impose more tax than is permitted by the OECD Model Treaty. Both of these models are discussed below.

Sections 8.2 through 8.6 below provide an overview of several of the most important general aspects of tax treaties, including the legal nature of tax treaties, their relationship with domestic law, their objectives, and the interpretation of treaties. The main features of the influential OECD and UN Model Treaties are summarized in section 8.7 in order to give readers a basic understanding of the provisions a typical tax treaty. Some special topics, including treaty abuse, nondiscrimination, resolution of disputes, and administrative cooperation, are examined in section 8.8.

Although this chapter focuses exclusively on income tax treaties, several other types of treaties deal with tax issues. For example, countries that impose estate or inheritance taxes may have treaties to eliminate double taxation with respect to those taxes. In addition, as of June 30, 2015 over ninety countries had signed the Multilateral Convention on Mutual Assistance in Tax Matters, sponsored by the OECD and the Council of Europe, which entered into force in 1995 and was significantly revised in 2011. This Convention deals with tax administration issues such as exchange of information, assistance in the collection of taxes, and dispute resolution. In addition, there are many types of treaties that deal primarily with non-tax matters but also include tax provisions. These non-tax treaties include air transportation agreements

and trade and investment treaties; most of these agreements contain carve-out provisions indicating that any income tax issues will be dealt with exclusively under the income tax treaty between the countries. The General Agreement on Tariffs and Trade (GATT), as renegotiated in 1994, and the General Agreement on Trade in Services (GATS), both of which were consolidated as part of the Agreement Establishing the World Trade Organization in 1994, contain some important provisions relating to income taxation, primarily designed to prevent the use of income tax provisions as disguised trade barriers or export incentives.

An important recent development is the proliferation of Tax Information Exchange Agreements (TIEAs), typically between high-tax countries and low- or no-tax countries with which the high-tax countries would not otherwise have a comprehensive income tax treaty. In general, TIEAs require the low- or no-tax countries to exchange information on the same basis as provided in Article 26 of OECD and UN Model Treaties.

Income tax treaties are invariably bilateral, rather than multilateral. Although proposals have been made from time to time for a multilateral income tax treaty, to date multilateral agreements have been limited to administrative issues. Countries seem to prefer customized agreements with each treaty partner that take into account the cross-border trade and investment flows between them and their income tax systems. However, trade and investment treaties, such as the GATT and the GATS, are multilateral agreements, and there is no legal impediment to a multilateral income tax treaty. In fact, a multilateral agreement is a much more efficient method of revising the vast network of bilateral treaties than renegotiating each treaty. In this regard, in BEPS Action 15: *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, the OECD has recently proposed producing a multilateral treaty to implement the changes to tax treaties that were recommended as part of the BEPS project (see section 8.8.2.3 below).

8.2 LEGAL NATURE AND EFFECT OF TAX TREATIES

8.2.1 *Vienna Convention on the Law of Treaties*

All treaties, including tax treaties, are governed by the *Vienna Convention on the Law of Treaties* ("Vienna Convention"), which was concluded on May 23, 1969 and entered into force on January 27, 1980. Although the Vienna Convention has not been signed by some countries (most notably, the United States (US)), it is generally considered to be binding on all nations because its provisions are a codification of the principles of customary international law dealing with treaties. All nations are considered to be subject to the principles of customary international law.

Treaties are agreements between sovereign nations. According to Article 2 of the Vienna Convention:

> A treaty is an international agreement (in one or more instruments, whatever called) concluded between states and governed by international law.

Thus, it does not matter that some tax treaties are called "conventions" and others are called "agreements."

Tax treaties confer rights and impose obligations on the parties or signatories to the treaty, called the contracting states. In most countries, they do not confer rights on citizens or residents of the two states unless and until the provisions of the treaty have been incorporated into the domestic laws of the contracting states in some manner. The methods for incorporating treaties into domestic law vary from country to country. In most Commonwealth countries, tax treaties are usually incorporated into domestic law by means of domestic legislation. In other countries, tax treaties are self-executing; they become part of domestic law once they are concluded and ratified by the responsible government officials. In other countries, treaties are subject to a special legislative process; for example, in the US, tax treaties entered into by the executive branch (the President) must receive the advice and consent of the US Senate before they become effective.

Article 26 of the Vienna Convention contains the *pacta sunt servanda* principle, under which treaties are binding on the contracting states and must be performed by them in good faith. Such a fundamental principle is self-evident. Treaties are binding agreements between sovereign states and must be respected by them - countries are unlikely to be interested in entering into treaties with countries that do not adhere to their obligations. Unfortunately, although the *pacta sunt servanda* principle is essential for treaties to operate as intended, there have been instances where countries have not respected the provisions of their tax treaties.

Reciprocity is a fundamental underlying principle of tax treaties, although its precise meaning is unclear. The provisions of almost all bilateral tax treaties are reciprocal. For example, if the rate of tax on dividends, interest, and royalties under a treaty is limited to 10 or 15 percent, that rate invariably applies equally to payments of these amounts by residents of one contracting state to residents of the other contracting state and by residents of the other state to residents of the first state. Moreover, the reciprocal limitation of the rates of tax imposed on dividends, interest, and royalties by the contracting states applies notwithstanding that the flows of these payments between the two contracting states may be unequal. The application of the principle of reciprocity is especially difficult with respect to provisions such as exchange of information and assistance in the collection of tax. These provisions impose potentially costly obligations on states. Although the provisions apply in the same manner in both states, does the principle of reciprocity require that both states make reasonably equal use of the provisions, or is it acceptable for one state to make disproportionate or even exclusive use of the provisions?

8.2.2 The Relationship between Tax Treaties and Domestic Law

The relationship between tax treaties and domestic tax legislation is much more complex than many commentators and tax professionals realize. Many of them think that the relationship consists of nothing more than the basic principle that a treaty prevails in the event of a conflict between the provisions of domestic law and the

treaty. In fact, the relationship between tax treaties and domestic law is complex, involving the following issues:

(1) the effect of tax treaties on subnational taxes;
(2) whether tax treaties limit domestic tax, allocate taxing rights, or impose tax;
(3) the limited impact of tax treaties in that they do not displace domestic law entirely;
(4) the incorporation of meanings of terms in domestic law into tax treaties;
(5) the incorporation of tax treaty terms into domestic law; and
(6) domestic laws that override the provisions of tax treaties.

These issues are discussed briefly below.

In general, tax treaties apply to all income taxes imposed by the contracting states, including taxes imposed by provincial (state), local, and other subnational governments. In some federal states, however, the central government is prevented by the constitution or established tradition from entering into tax treaties that limit the taxing powers of their subnational governments. Accordingly, the tax treaties of some federal states, such as Canada and the US, apply only to national taxes. In such circumstances, a subnational government may impose taxes that contravene the provisions of an applicable tax treaty despite the fact that the central government could not impose similar taxes.

In general, tax treaties do not impose tax, nor do they allocate taxing rights between the contracting states - the right to tax is derived from the domestic law of a state. Tax treaties limit the taxes otherwise imposed by a state; in effect, they are primarily relieving in nature. France and several African countries that follow the French practice are notable exceptions in this regard because taxes may be imposed pursuant to treaty provisions even where they are not imposed under domestic law. In other words, these countries impose tax on amounts that a treaty allows them to tax, despite the fact that those amounts may not be taxable under their domestic law. In contrast, for most countries, if an amount is not taxable under domestic law, that is the end of the matter; it is unnecessary to refer to the treaty.

The provisions of tax treaties do not displace the provisions of domestic law entirely. For example, a person who is considered to be a resident of both Country A and Country B under their domestic laws may be deemed to be a resident of Country A pursuant to the tie-breaker rule in the treaty between Country A and Country B. Article 4(2) (Resident) of both the OECD Model and UN Model Treaties provides a series of tie-breaker rules to make a dual-resident individual a resident of only one country for purposes of the treaty. However, although the individual may be considered to be a resident of Country A for purposes of the treaty, the individual will remain a resident of Country B under its domestic law for all purposes not affected by the treaty. If, for example, the individual makes payments of dividends, interest, or royalties to nonresidents, the person may be subject to any withholding obligations imposed by Country B on such payments made by residents of Country B.

Many tax treaty provisions include explicit references to the meaning of terms under domestic law. As a result, the meanings of terms in a tax treaty are determined

by reference to the meanings of those terms under the domestic law of the contracting states. For example, under Article 6 (Income from Immovable Property) of both the OECD and UN Model Treaties, income from immovable or real property located in a country is taxable by that country. For this purpose, the term "immovable property" is defined in Article 6(2) to have the meaning that it has under the domestic law of the country in which the property is located. In addition, Article 3(2) (General Definitions), which is discussed below, provides that any undefined terms in a treaty should be given the meaning that they have under the law of the country applying the treaty. Conversely, in some countries where the domestic law uses terms that are also used in the treaty, the meaning of those terms for purposes of domestic law may be interpreted in accordance with the meaning of the terms for purposes of the treaty. In effect, in these circumstances, treaty meanings are incorporated into domestic law.

As noted above, as a general rule, the provisions of tax treaties prevail in the event of a conflict with the provisions of domestic law. In some countries, this principle is enshrined in the constitution; in other countries, it is enacted as a statutory rule; in yet other countries, treaties prevail over other laws because they are considered to be special (*lex specialis*). In the US, the basic rule for resolving conflicts between statutes and treaties is that the later-in-time prevails. Except in countries that give constitutional priority to treaties, it is possible for countries to adopt legislation that takes priority over their tax treaties. Such legislation is often referred to as a **treaty override**. For example, some countries have passed legislation to modify or overturn the interpretation of a tax treaty by its domestic courts, perhaps on the basis that the court decisions are inconsistent with the Commentary on the OECD or UN Model Treaties or the intentions of the contracting states. Such legislation, adopted in good faith, may not violate a country's obligations under its tax treaties. A country contemplating a treaty override may consult with its treaty partners in advance to demonstrate good faith and prevent misunderstandings.

Occasionally, some countries have included treaty overrides in legislation to prevent taxpayers from arguing in court that the countries' tax treaties prevent the application of the legislation. This type of treaty override is very controversial. Tax treaties are solemn obligations that should not be disregarded except in extraordinary circumstances. If a country becomes dissatisfied with the provisions of a tax treaty, the appropriate remedy is the renegotiation or termination of the treaty. At the same time, countries must have the ability to amend the provisions of their domestic tax legislation to keep it current and to clarify interpretive difficulties concerning the relationship between the treaty and domestic law.

8.3 THE OECD AND UN MODEL TAX TREATIES

There are two influential model tax treaties - the OECD *Model Tax Convention on Income and on Capital* (available at www.oecd.org) and the United Nations *Model Double Taxation Convention between Developed and Developing Countries* (available at www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf), the most recent versions of which are 2014 and 2011 respectively. Some countries have their own model

tax treaties, which are often not published but are provided to other countries for the purpose of negotiating tax treaties. The US has published its model treaty, available at www.irs.gov. The UN Model Treaty and the various country models are broadly similar to the OECD Model Treaty and can be viewed as modified versions of the OECD Model Treaty rather than as separate models.

The OECD Model Treaty has a long history, beginning with early diplomatic treaties of the nineteenth century. The limited objective of those treaties was to ensure that diplomats of one country working in another would not be discriminated against; they were extended to cover income taxation once income taxes began to be widely adopted in the early part of the twentieth century. After the First World War, the League of Nations commenced work on the development of a model treaty dealing exclusively with income tax issues. This work culminated in draft model conventions in 1943 and 1946. These conventions were not unanimously accepted, and the work of creating an acceptable model treaty was taken over by the OECD. Currently, the OECD has thirty-four members, consisting of most of the major industrialized countries. Membership in the OECD has recently been extended to Chile, Estonia, Israel, and Slovenia. It seems likely that several other countries, such as Colombia, Costa Rica, Latvia, and Lithuania will become members in the near future.

The OECD Model Treaty was first published, in draft form, in 1963. It was revised in 1977 and again in 1992. In 1992, the OECD decided that the Model Treaty should be ambulatory, with more frequent, periodic updates rather than complete revisions at less frequent intervals. Consequently, since 1992 the OECD Model Treaty has been revised nine times: in 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010 and, most recently, 2014. The Committee on Fiscal Affairs, which consists of senior tax officials from the member countries, has responsibility for the Model Treaty as well as other aspects of international tax cooperation. The Committee on Fiscal Affairs operates through the Centre for Tax Policy and Administration, which was created in early 2001; it has a large staff that deals with various aspects of international taxation, including tax treaties, and oversees several Working Parties. The Working Parties consist of delegates from the member countries; Working Party No. 1 is responsible for the Model Treaty and examines issues related to the treaty on an ongoing basis.

The work of the United Nations on a model treaty commenced in 1968 with the establishment by the UN Economic and Social Council (ECOSOC) of the UN Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries. The Group of Experts produced a *Manual for the Negotiation of Bilateral Tax treaties between Developed and Developing Countries*, which led to the publication of the UN *Model Taxation Convention between Developed and Developing Countries* in 1980. The UN Model Treaty was revised in 2001 and again in 2011. In 2004, the Group of Experts became the Committee of Experts on International Cooperation in Tax Matters. In addition to maintaining the UN Model Treaty and its **Commentary**, the Committee has published several useful reference works dealing with international tax, including a manual on transfer pricing for developing countries and a handbook on the administration of tax treaties.

The members of the Committee are tax officials nominated by their governments and appointed by the Secretary-General of the UN. They serve for four-year terms in

their individual capacity rather than as representatives of their governments; however, the practical reality is that many members of the Committee usually adopt positions that are consistent with those of their governments. A majority of the members of the Committee are from developing countries and countries with economies in transition. The members of the Committee are tax specialists and include several treaty negotiators.

The UN Model Treaty follows the pattern set by the OECD Model Treaty, and many of its provisions are identical, or nearly identical, to those of the OECD Model Treaty. The chief difference between the two models is that the UN Model Treaty imposes fewer restrictions on the taxes that may be imposed by developing countries. For example, the UN Model Treaty does not contain specific limitations on withholding tax rates on dividends, interest, and royalties imposed by source countries; instead, the withholding rate levels are left to bilateral negotiations between the contracting states. Similarly, as discussed in section 8.7.3.2 below, the UN Model Treaty allows source countries to tax more cross-border business profits than the OECD Model by lowering the threshold for a PE.

A detailed Commentary, organized on an article-by-article basis, accompanies both the OECD and the UN Model Treaties. In particular, the OECD Commentary has become increasingly important with respect to the interpretation and application of tax treaties, including treaties between countries that are not members of the OECD. To take into account the positions of some non-member states, the OECD opened up the Commentary in 1997 for non-member countries to register their positions on the provisions of the OECD Model Treaty and its Commentary. As of 2014, thirty-three countries have done so.

In general, and in comparison to the UN Model Treaty, the OECD Model Treaty favors capital-exporting (residence) countries over capital-importing (source) countries. Often it eliminates or mitigates double taxation by requiring the source country to give up some or all of its taxing rights on certain categories of income earned by residents of the other treaty country. This aspect of the OECD Model is appropriate if the flow of trade and investment between the two countries is reasonably equal and the residence country taxes any income that the source country exempts from tax. The following example illustrates this point.

Country A and Country B are both developed countries contemplating a tax treaty. Both countries tax their residents on a worldwide basis, and both provide their residents with a foreign tax credit for withholding taxes paid with respect to foreign source income. Country A has one taxpayer, Taxpayer A, who earns royalties of 1,000 from Country B. Country B likewise has one taxpayer, Taxpayer B, who earns royalties of 1,000 from Country A. Absent a treaty, Country B would impose a 15 percent withholding tax on royalties paid to Taxpayer A, and Country A would do the same with respect to royalties paid to Taxpayer B. Country B would allow Taxpayer B to claim a foreign tax credit for the withholding taxes paid to Country A, and Country A would allow a credit for the comparable taxes paid by Taxpayer A to Country B. If the two countries agree in their tax treaty to reduce withholding at source on royalties to a rate of zero for residents of the other contracting state, each country would thereby lose

source-tax revenue of 150 (1,000 × 0.15). They would recoup the lost source-tax revenue, however, by collecting 150 in additional tax from their own residents.

Two important points may be drawn from the above example. First, a country that gives up the domestic tax that it imposes on income derived from its territory cannot expect to recoup the lost revenue from an expansion of its residence jurisdiction if it uses an exemption system to relieve international double taxation.

Second, a trade off of domestic tax based on the source of income for tax, which is based on the residence of the taxpayer, is likely to be unfavorable for a country that is a net importer of capital. Of course, investment flows between two contracting states are never as exact as in the above example; some deviations from strict reciprocity are acceptable, especially for countries with a network of tax treaties. If a group of countries enters into bilateral treaties based on the OECD Model Treaty, what is important is that the investment flows within that group be roughly in balance. In such circumstances, a country that loses revenue under some of its treaties can expect to recoup the revenue under other treaties.

Developing countries are net capital importers, and many of them use the exemption method for granting double taxation relief to their resident taxpayers. Consequently, developing countries entering into a tax treaty with a developed country would not benefit from the trade-off of taxation based on the source of income for taxation, based on the residence of taxpayers, contained in the OECD Model Treaty. As noted above, because of the shortcomings of the OECD Model Treaty, developing countries devised their own model treaty under the auspices of the UN.

The success of the OECD Model Treaty has been remarkable - virtually all existing bilateral tax treaties are based on it. As noted above, even the UN Model Treaty and US Model Treaty follow the basic pattern of the OECD Model Treaty. This wide acceptance of the OECD Model Treaty, and the resulting standardization of many international tax rules, has been an important factor in reducing international double taxation and facilitating international trade and investment.

Nevertheless, the OECD Model Treaty has several deficiencies. For example, some provisions are intentionally vague in order to disguise disagreements among OECD member countries. Also, many important aspects of international tax, such as foreign-currency gains and losses, sophisticated financial arrangements, cross-border reorganizations, and corporate integration methods, are not dealt with in the Model Treaty at all. Moreover, in some ways the OECD Model Treaty is a victim of its own success. Changing the articles of the OECD Model Treaty to correct flaws and respond to new developments is extremely difficult. One source of this difficulty is that countries can adopt revisions of the OECD Model Treaty only by renegotiating their existing treaties, which is time-consuming, especially for countries with large treaty networks.

Another source of difficulty is the OECD tradition of amending the Model Treaty only with the unanimous consent of all OECD members. The practical significance of the unanimity rule is diminished because member countries that disagree with any aspect of the Model Treaty can register a reservation to the particular provision of the Model Treaty. These reservations are found in the Commentary on the Model Treaty. A reservation indicates that the country does not intend to adopt the particular

provision of the OECD Model Treaty in its tax treaties. Most countries have entered reservations on some aspects of the Model Treaty. For example, fourteen member countries have entered reservations on Article 12 dealing with royalties by asserting their intention to levy withholding taxes on royalties.

The Commentary also contains observations by particular countries on specific aspects of the Commentary. Observations are usually used to indicate that a particular country's interpretation of a provision of the Model Treaty or a part of the Commentary differs from the interpretation of the majority of the member countries. A country making an observation does not reject the particular article of the Model Treaty. The purpose of the observation is to indicate that the country will include the provision in its treaties, but will interpret and apply the provision in a manner different from the view expressed in the Commentary. A country is not expected to enter an observation if the Commentary sets out alternative positions and the country adopts one of those positions.

The Commentary on the OECD Model Treaty is much easier to change than the articles of the Model Treaty itself. According to the Commentary, the views expressed in the Commentary, subject to any reservations or observations, should be taken into account in interpreting and applying all treaties between Member States, even those treaties entered into before the revisions of the Commentary. This practice of applying revisions of the Commentary to previously existing tax treaties raises some interesting questions of interpretation that are dealt with in section 8.6 below.

8.4 THE PROCESS OF NEGOTIATING AND REVISING TAX TREATIES

The negotiation of a tax treaty typically begins with initial contacts between the countries. Usually, a country will consider many factors, including the level of trade and investment with another country, in deciding whether to enter into negotiations for a tax treaty with that country. Once the countries have decided to negotiate, they exchange their model treaties (or their most recent tax treaties, if they do not have a model treaty) and schedule face-to-face negotiations.

Traditionally, treaties are negotiated in two rounds, one in each country. During the first round of negotiations, the negotiating teams agree on a particular text - usually the OECD Model or UN Model Treaty - to use as the basis for the negotiations. After presentations by both sides about their domestic tax systems, the negotiations proceed on an article-by-article basis. Aspects of the text that cannot be agreed on are usually placed in square brackets, to be dealt with later. Once the wording of an article is agreed on, the parties initial it. Once all the articles have been agreed on by the treaty negotiators, arrangements are made for the treaty to be signed by an authorized official (often an ambassador or government official). After signature, each state must ratify the treaty in accordance with its own ratification procedures. The treaty is concluded when the countries exchange instruments of ratification. The treaty enters into force in accordance with the specific rules in the treaty (Article 30 (Entry into Force) of the OECD Model Treaty and Article 29 (Entry into Force) of the UN Model Treaty).

Thus, the process for the adoption of a tax treaty involves several separate steps or stages: signature, ratification, conclusion, and entry into force. Each of these steps has a special meaning and particular consequences.

Once a treaty has been adopted, it may be modified in minor or major ways by the mutual consent of the contracting states. It is common for a tax treaty to be amended by the parties entering into a Protocol to the treaty. Under the provisions of the Vienna Convention as discussed in section 8.2.1 above, an agreement designated as a Protocol is simply a treaty under a different name. Thus, as described above, it must be ratified under the rules applicable to treaties before it becomes effective.

Tax treaties require updating just like domestic tax laws. In practice, the amendment process is often exceedingly slow and difficult - it is not uncommon for a Protocol to take as long to negotiate as a treaty. Often, once one aspect of a treaty is opened up for renegotiation, other aspects of the treaty become negotiable. Consequently, if a country has a broad network of tax treaties - some have tax treaties with over 100 countries - the renegotiation of the entire network could take decades.

To a limited degree, tax treaties may be updated without a formal amendment procedure through the interpretive process. For example, as discussed in section 8.3 above, the OECD Commentary is frequently updated to clarify the meaning of the articles of the treaty, and the OECD takes the position that the revisions to the Commentary should be applied to tax treaties that were entered into before those revisions were made (see paragraphs 33-36 of the Introduction to the OECD Model Treaty). In addition, Article 25 (Mutual Agreement Procedure) of both the OECD and UN Model Treaties authorizes the competent authorities of the two states to resolve issues of interpretation. The general rules for interpreting treaties are discussed below in section 8.6.

8.5 OBJECTIVES OF TAX TREATIES

The fundamental objective of tax treaties, broadly stated, is to facilitate cross-border trade and investment by eliminating the tax impediments to these cross-border flows. This broad objective is supplemented by several more specific operational objectives.

From the perspective of taxpayers, the most important operational objective of bilateral tax treaties is the elimination of double taxation. Several provisions of the typical bilateral tax treaty are directed at the achievement of this goal. For example, tax treaties contain tie-breaker rules (Article 4(2) and (3) of the OECD and UN Model Treaties) to deem a taxpayer who is otherwise resident in both countries to be a resident of only one of the countries. They also limit or eliminate the source country tax on certain types of income (Articles 10, 11 and 12 of the OECD and UN Model Treaties) and require residence countries to provide relief for source country taxes, either by way of a foreign tax credit or an exemption for the foreign source income (Article 23 of the OECD and UN Model Treaties). The mechanisms for granting relief from double taxation are discussed in Chapter 4, section 4.3.

In the mid- twentieth century, the focus of tax treaties was almost exclusively on solving the problem of double taxation. This focus was reflected in the title of the 1963

and 1977 OECD Model Treaties: "Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital." At that time, multinational enterprises were facing risks of substantial double taxation, few countries provided unilateral relief for double taxation, and widespread treaty networks were just starting to develop. Treaty solutions to most of the major double-tax problems were worked out in the 1950s and early 1960s, however, and they are now routinely accepted by states when they enter into tax treaties.

The historical emphasis on the elimination of double taxation should not obscure the fact that most tax treaties have another equally important operational objective – the prevention of tax evasion and avoidance. This objective is the converse of the elimination of double taxation. Tax treaties are intended to eliminate double taxation of cross-border income, but are not intended to facilitate double non-taxation. The underlying assumption of tax treaties is that cross-border income should be taxed, but should be taxed only once.

Originally, the OECD and UN Model Treaties included a preamble stating that the treaty was intended to eliminate double taxation and prevent fiscal evasion. The meaning of the term "fiscal evasion" was unclear; some countries interpreted it broadly to include tax avoidance while others, such as Switzerland, restricted the term to criminal tax evasion. The references in the preamble to the avoidance of double taxation and prevention of fiscal evasion were eliminated from the OECD and UN Model Treaties and moved to a footnote in 1992 and 2001 respectively. However, in 2003 the Commentary on the OECD Model Treaty was revised to include an explicit statement that "[I]t is also a purpose of tax conventions to prevent tax avoidance and evasion" (paragraph 7 of the Commentary on Article 1). Although the Commentary on the UN Model Treaty does not reproduce this sentence from the OECD Commentary, it is reasonably clear from the UN Commentary on Article 1 that one of the important purposes of the treaty is to prevent tax avoidance and the improper use of the treaty.

The increasing focus on the use of tax treaties to facilitate tax avoidance led the OECD, as part of the BEPS project, to recommend changes to the title and preamble of the OECD Model Treaty to refer explicitly to the prevention of tax avoidance (see BEPS Action 6: *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, available at www.oecd.org and discussed in section 8.8.2.3). The proposed title of the OECD Model Treaty will be "Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance." The proposed preamble will also include explicit references to double non-taxation and treaty shopping:

> Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).

Although the elimination of tax avoidance and evasion is an explicit objective of most tax treaties, few provisions in those treaties are designed to achieve that objective. Both the OECD and UN Model Treaties contain provisions for the exchange of

information (Article 25) and assistance in the collection of taxes (Article 27). These provisions give the contracting states two important tools to prevent tax avoidance and evasion; however, neither Model Treaty currently contains any general anti-avoidance rule, and both Model Treaties contain few specific anti-avoidance rules. The OECD BEPS Action 6 proposes to add a detailed anti-treaty shopping rule similar to the limitation-on-benefits provision included in US tax treaties; it also proposes to add a general anti-abuse provision to the OECD Model, under which treaty benefits would be denied if one of the principal purposes of a transaction or arrangement was to avoid tax, unless the treaty benefits are in accordance with the object and purpose of the treaty. See sections 8.8.2.1 and 8.8.2.2 for a discussion of treaty abuse and treaty shopping respectively.

In addition to the two principal operational objectives of tax treaties, there are several other ancillary objectives. One ancillary objective, which is discussed in section 8.8.1, below, is the elimination of discrimination against foreign nationals and nonresidents. Most countries entering into tax treaties want to ensure that their residents are treated the same as residents of the other contracting state, and certainly no worse than residents of any third state. Other ancillary objectives, discussed in section 8.8.4 below, are the exchange of information between the contracting states and assistance in the collection of taxes. As noted above, allowing countries to obtain information about the income-earning activities of taxpayers is an important tool in combating tax avoidance and, more generally, in ensuring that the provisions of the treaty are applied properly. Similarly, requiring countries to provide assistance in collecting the taxes imposed by their treaty partners can prevent taxpayers from avoiding and evading tax by moving to another country or hiding assets or funds in another country. Finally, most contracting states provide a mechanism in their treaties for resolving disputes with respect to the application of the treaty and, in particular, transfer pricing disputes. Dispute-resolution mechanisms are discussed in section 8.8.3, below.

An important effect of tax treaties - and an implicit purpose - is to provide certainty for taxpayers with respect to the tax consequences of cross-border investment. Investors like certainty. Tax treaties have an average life of approximately fifteen years. As a result, nonresident investors know that, despite changes that will inevitably be made to the tax laws of the source country, the basic limitations in the treaty on the source country's right to tax will prevent future changes from affecting those limitations. For example, if Company A, a resident of Country A, makes an investment in the shares of Company B, a resident Country B, Company A knows that the limit provided in the treaty between Country A and Country B on the rate of withholding tax imposed by Country B on dividends will continue to apply even if Country B increases the rate of withholding tax on dividends under its domestic law.

Another important effect, and an implicit objective, of a tax treaty is the allocation of tax revenues from cross-border activity between the two contracting states. The provisions of tax treaties determine how much tax revenue from the cross-border activity between the two states will be subject to tax by each of those states. For example, if Country A agrees to include in its treaty with Country B a provision similar

to Article 12 of the OECD Model Treaty dealing with royalties, any royalties paid by residents of Country A to residents of Country B will be taxable exclusively by Country B, and vice versa. If royalty flows between Country A and Country B are relatively equal, the allocation of the tax revenues from those flows will also be relatively equal. However, if the flows are disproportionately from residents of Country A to Country B (as would usually be the case if Country A is a developing country and Country B is a developed country), the tax revenues would be allocated disproportionately to Country B. Country A might attempt to avoid this result by insisting that Article 12 of the treaty allow the source country to tax royalties paid by its residents to residents of the other country at a limited rate of, say 15 percent. In this case, Country A would derive tax revenues equal to 15 percent of any royalties paid by its residents to residents of Country B, and Country B would derive tax revenues equal to its tax rate on royalties derived by its residents from residents of Country A, less 15 percent of those royalties.

8.6 INTERPRETATION OF TAX TREATIES

8.6.1 Introduction

In certain respects, the interpretation of tax treaties is similar to the interpretation of domestic tax legislation. The meaning of the words of the treaty, the context in which they are used, and the purpose of the treaty are generally important factors in interpreting both treaties and domestic tax legislation. As a result, it seems likely that a country's tax authorities and its courts would interpret tax treaties in the same manner as domestic tax legislation. There are, however, several important differences between tax treaties and domestic tax legislation:

(1) Because tax treaties are bilateral, questions of interpretation should be resolved by reference to the intentions of both states.
(2) Tax treaties are addressed to both the governments and the taxpayers of both countries, whereas domestic tax legislation has a narrower scope.
(3) Tax treaties are often drafted using different terms from those used in domestic legislation. For example, the OECD and UN Model Treaties use the term "enterprise," which is not used in the domestic legislation of many countries.
(4) Unlike domestic tax legislation, tax treaties do not generally impose tax; they limit the taxes imposed by the contracting states.
(5) The influential OECD Model Treaty and Commentary and the UN Model Treaty and Commentary have no counterparts in the context of domestic tax legislation.

These differences may suggest that tax treaties should be interpreted differently from domestic tax legislation. However, the interpretation of any language, including the provisions of tax treaties and domestic tax rules, is a matter of judgment that cannot be reduced to mechanical rules.

8.6.2 The Interpretive Provisions of the *Vienna Convention on the Law of Treaties*

The interpretation of tax treaties is governed by customary international law, as embodied in the *Vienna Convention on the Law of Treaties*. The interpretive rules of the Vienna Convention apply to all treaties, not just tax treaties. As discussed in section 8.2.1 above, the provisions of the Vienna Convention are binding on all nations because they represent a codification of customary international law.

Article 31(1) of the Vienna Convention provides a basic rule for the interpretation of treaties:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.

Under Article 31(2), the context of a treaty includes the text of the treaty, any agreements between the parties made in connection with the conclusion of the treaty, and any instrument made by one party and accepted by the other party. For example, the US produces a technical explanation for each of its tax treaties, and Canada publicly announced its acceptance of the US technical explanation of the US-Canada treaty. Under Article 31(3), subsequent agreements between the parties to the treaty and their subsequent practice with respect to the interpretation of the treaty, and any applicable rules of international law, must also be taken into account, together with the context. Article 31(4) provides that a treaty term may have a special meaning rather than its ordinary meaning if it is established that the parties so intend. The Commentary on the OECD or UN Model Treaty may provide evidence that a term is intended to have a special meaning.

The basic interpretive rule in Article 31(1) of the Vienna Convention makes intuitive sense. Obviously, the first step in any interpretive exercise must be to carefully consider the ordinary meaning of the words of the treaty. And those words must be read in their context - the particular provision in which the words are used and the treaty as a whole - because the meaning of words is always dependent on the context in which they are used. It also makes sense to interpret the terms of a treaty in light of the purpose of the provision and the treaty as a whole because, obviously, the contracting states are trying to accomplish something by entering into the treaty and agreeing on its terms.

Although Article 31(1) of the Vienna Convention makes sense, it must also be acknowledged that it is vague and does not provide any clear, meaningful guidance for taxpayers, tax authorities, or courts about how to interpret treaties. Most importantly, it does not indicate how much weight to give to the ordinary meaning of the words, the context, and the purpose of the relevant provisions of the treaty in any particular case. For example, if there is a conflict between the ordinary meaning of the words and the purpose of the relevant provision, Article 31(1) does not indicate how the conflict should be resolved. Although most courts and commentators would take the position that words with a relatively clear meaning should not be disregarded in order to carry

out an unexpressed, uncertain purpose, it is difficult to write an interpretive rule as to how all the relevant factors should be weighed in any particular case.

Under Article 32 of the Vienna Convention, other material, referred to as supplementary means of interpretation, which includes the *travaux préparatoires* (preparatory work) of the treaty, should be considered only to confirm the meaning established pursuant to Article 31, or to establish the meaning if applying Article 31 produces an ambiguous, obscure, absurd, or unreasonable result.

Although the Commentaries on the OECD and UN Model Treaties are very important for the interpretation of tax treaties, their legal status under the provisions of the Vienna Convention is unclear. At first glance, they appear to be supplementary means of interpretation under Article 32. If so, they are relevant only to confirm the meaning otherwise established by the application of the basic interpretive rule in Article 31, or to establish the meaning if the meaning under Article 31 is ambiguous, obscure, absurd, or unreasonable. The OECD does not intend for the Commentary to have such a limited role. In the Introduction to the Commentary, it is stated that the Commentary "can be ... of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes" (paragraph 29). It is difficult, however, to justify including the Commentary as part of the context of a treaty under Article 31 of the Vienna Convention, especially if the treaty being interpreted was entered into before the Commentary was revised, or if one of the contracting states is not a member of the OECD and therefore had no part in the preparation of the Commentary.

Although the status of the OECD Model Treaty and Commentary under the Vienna Convention is a controversial topic among international tax scholars, the issue appears to be of little practical significance. In treaty cases from virtually all countries, the courts invariably give the OECD Model Treaty and Commentary substantial weight.

The provisions of tax treaties should be interpreted in the same way in both countries (the principle of common interpretation) because otherwise income may be taxed twice, or not at all. Assume, for example, that Company A, a resident of Country A, performs services in Country B for the benefit of Company B, a resident of Country B. The services result in the creation of some work product used by Company B. Company A receives a payment from Company B that is characterized under the laws of Country B as compensation for services performed in Country B. In contrast, Country A characterizes the payment as a royalty for allowing Company B to use Company A's work product. Under the tax treaty between the two countries, fees for personal services are taxable in the source state, but royalties are taxable exclusively by the residence state. Under these circumstances, Company A will be subject to double taxation unless the competent authorities of the two countries can resolve the matter. Country B will impose tax on Company A's income in accordance with Article 7 of the treaty (assuming that Company A has a PE in Country B); in contrast, Country A will impose tax on the payments received by Company A as royalties under Article 12 of the treaty. Country A may not provide any relief for the tax imposed by Country B because Country B's tax is not imposed on the royalties.

Several countries have multiple official languages. When these countries enter into tax treaties, there may be multiple official versions of the treaty in different

languages. Article 33 of the Vienna Convention provides that all versions of tax treaties concluded in multiple languages are considered to be equally authentic unless the provisions of the treaty specify that one version is to govern in the event of a conflict. Some countries that conclude their tax treaties in multiple languages, such as China, provide that the English-language version of the treaty will prevail where the versions conflict.

8.6.3 The Interpretation of Undefined Terms in Accordance with Domestic Law – Article 3(2)

In addition to the provisions of the Vienna Convention, tax treaties based on the OECD and UN Model Treaties contain an internal rule of interpretation. Article 3(2) of the OECD and UN Model Treaties provides as follows:

> As regards the application of the Convention at any time by a contracting state, any term not defined therein shall, unless the context requires otherwise, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

In effect, Article 3(2) provides that undefined terms used in the treaty have the meaning that they have under the domestic law of the country applying the treaty unless the context requires otherwise. For this purpose, a country applies a treaty when it takes any relevant action with respect to the treaty, such as issuing a ruling or an assessment of tax.

The application of Article 3(2) involves a three-stage process:

(1) Does the treaty provide a definition of the term?
(2) If the treaty does not provide a definition of the term, what is its domestic meaning?
(3) Does the context of the treaty require a meaning different from the domestic meaning?

The first step is not as simple as it appears, in part because some definitions in tax treaties are inclusive, while others are exclusive. For example, Article 3(1)(a) defines a "person" to include an individual, a company, and any other body of persons. In contrast, the definition of "company" in Article 3(1)(b) is exclusive ("company means ..."). Generally, an inclusive definition means that the term has its ordinary meaning plus the items that are specifically mentioned. Does Article 3(2) apply to determine the ordinary meaning under domestic law of terms that are defined inclusively, such as "person"? In my view, Article 3(2) should apply in these circumstances so that the term "person" would include any legal entity that is considered to be a person under the domestic law of the state applying the treaty. A further difficulty is that definitions in a treaty often contain terms that are undefined; for example, the terms "individual" and

"body of persons" in Article 3(1)(a) are not defined. Again, in my view, these terms should take their meaning from domestic law by virtue of Article 3(2).

The determination of the meaning of a term under domestic law may also be difficult. Article 3(2) provides that the meaning of an undefined term under a country's tax law prevails over the meaning under other domestic laws. An undefined term, however, may have more than one meaning for purposes of a country's tax law. In this situation, the domestic meaning that is most appropriate should be used for purposes of the treaty. Also, Article 3(2) refers to the "meaning" of an undefined term, not to its definition, under domestic law. A term may not be defined for purposes of a country's tax law, but it should have an ordinary meaning.

The final step in the application of Article 3(2) is to consider whether the context of the treaty requires a term to be given a different meaning from its meaning under domestic law. For this purpose, it is necessary to consider alternative meanings for the term for purposes of the treaty and whether one of these meanings is more appropriate in the context of the treaty than the domestic law meaning. Matters that should be considered in this analysis include:

- the ordinary meaning of the term as compared to the meaning under the domestic tax law;
- the meaning of the term under the other country's tax law;
- the purpose of the relevant provision of the treaty; and
- extrinsic material such as the Commentary on the OECD or UN Model Treaty.

Some international tax scholars argue that in applying Article 3(2), if at all possible, undefined terms should be given a meaning that is independent of domestic law and that a domestic law meaning should be used only as a last resort. Other scholars argue that Article 3(2) contains a preference for domestic law meanings because those meanings are displaced by treaty meanings only if "the context requires otherwise." The use of the word "requires," they argue, places a substantial onus on those seeking to justify a treaty meaning.

In my view, Article 3(2) does not establish any clear preference for domestic law meanings or treaty meanings for undefined terms. Furthermore, there are no strong arguments for establishing any residual presumption in favor of either a domestic or treaty meaning of an undefined term. As noted above, the meaning of undefined terms in a tax treaty should be determined by reference to all the relevant information.

Another important and controversial issue of interpretation in connection with Article 3(2) of the OECD and UN Model Treaties is whether a term has its meaning under domestic law at the time that the treaty was entered into (the static approach) or its meaning under domestic law as amended from time to time (the ambulatory approach). Article 3(2) of the OECD Model Treaty was amended in 1995 to clarify that Article 3(2) should be applied in accordance with the ambulatory approach. A similar conforming amendment was made to the UN Model Treaty in 2001. The ambulatory approach allows treaties to accommodate necessary changes to domestic law without the need to renegotiate the treaty. As a result, the ambulatory approach effectively permits a country to unilaterally amend its tax treaty with another country by changing

its domestic law. However, an amendment to domestic law that significantly alters the bargain between the two countries, and was not contemplated by both countries when the treaty was negotiated, is equivalent to a treaty override.

8.7 SUMMARY OF THE PROVISIONS OF THE OECD AND UN MODEL TREATIES

8.7.1 Introduction

This section describes the major provisions of the OECD and UN Model Treaties. Section 8.7.2 describes the provisions that identify the parties to a treaty and the persons whose tax obligations are affected by it, that establish the scope of the treaty, and that govern its ratification, termination, and amendment. Section 8.7.3 describes the treatment of various categories of income under a typical tax treaty; these provisions are known as the distributive rules of a treaty. Section 8.7.4 describes the rules dealing with administrative matters and cooperation between the treaty partners.

Every tax treaty includes some provision for relieving or mitigating double taxation. In the OECD and UN Model Treaties, relief from double taxation is provided either by Article 23A (Exemption Method) or Article 23B (Credit Method). Methods of providing relief from double taxation are discussed in Chapter 4.

To prevent tax avoidance through transfer pricing, the domestic tax laws of most countries give the tax authorities the power to adjust prices in transactions between related persons to reflect the prices that would have prevailed if the transaction had taken place at arm's length with an unrelated person. Article 9 (Associated Enterprises) of the OECD and UN Model Treaties provides that the contracting states are permitted (indeed, expected) to adjust prices and recompute profits from related-party transactions in accordance with this so-called arm's-length standard. Transfer pricing and the arm's-length standard are discussed in Chapter 6.

8.7.2 Coverage, Scope, and Legal Effect

The two countries that enter into a bilateral income tax treaty are called the "contracting states." Under Article 1 (Personal Scope) of the OECD and UN Model Treaties, the provisions of the treaty apply to persons who are "residents of one or both of the contracting states." Article 4 (Resident) defines a "resident" of a contracting state for purposes of the treaty as a person who is liable to tax under the domestic laws of that contracting state on the basis of certain connecting factors, such as residence, domicile, place of management, or other similar criterion. As discussed in Chapter 2, section 2.2.3, Article 4 also includes tie-breaker rules that prevent a person from being a resident of both contracting states for purposes of the treaty. A "person" is defined in Article 3 (General Definitions) to include "an individual, a company and any other body of persons." The OECD Commentary indicates that a charitable foundation is a "person" within the meaning of Article 3 - indeed, any legal entity that is recognized

under the laws of a contracting state is likely to be treated as a "person" for tax treaty purposes. Although a partnership is probably a body of persons and therefore a person for purposes of the OECD and UN Model Treaties, it may not be a resident of a contracting state if the partners rather than the partnership are liable to tax in that state.

Article 2 (Taxes Covered) of the OECD and UN Model Treaties specifies that the treaty applies "to taxes on income and on capital imposed on behalf of a contracting state or of its political subdivisions or local authorities." Some treaties do not extend coverage to subnational income taxes. Despite any limitations in Article 2, Articles 24, 26 and 27 of the OECD and UN Model Treaties dealing with nondiscrimination, exchange of information, and assistance in the collection of taxes apply to all taxes imposed by the contracting states and not just those taxes described in Article 2.

The typical tax treaty expressly lists the national taxes (and sometimes the subnational taxes) of the contracting states to which the treaty applies. Each country's personal income tax and corporate income tax are invariably listed. Most treaties also provide that the treaty applies to amendments of the listed taxes and to subsequently imposed taxes that are identical or substantially similar to the listed taxes. Some treaties also list certain income and capital taxes that are not to be covered by the treaty; for example, many tax treaties exclude from their scope payroll and social security taxes earmarked for government pensions.

According to Article 30 (Entry into Force) of the OECD Model Treaty and Article 29 (Entry into Force) of the UN Model Treaties, tax treaties become effective on ratification and the states should agree to exchange instruments of ratification as soon as possible. Each contracting state has its own internal procedures for ratifying treaties that must be satisfied. For example, many countries provide that a treaty negotiated by the government must receive legislative approval to be effective. Once these internal procedures have been satisfied, the contracting states will exchange instruments of ratification. Generally, tax treaties become effective on the first day of the calendar year following the exchange of the instruments of ratification with respect to provisions of the treaty that apply on the basis of taxation years, such as Article 7 (Business Profits). Other provisions of the treaty, such as the provisions dealing with withholding rates in the source country, may take effect earlier or later than the rest of the treaty. In addition, certain provisions of the OECD and UN Model Treaties may apply retrospectively. For example, a request for information or for assistance in the collection of taxes may relate to a year before the treaty entered into force. Such a request is valid as long as it is made after the treaty becomes effective.

Although tax treaty partners contemplate that their relationship will last indefinitely, their treaties provide for the termination of the treaty at the request of either party. Under Article 31 (Termination) of the OECD Model Treaty and Article 30 (Termination) of the UN Model Treaty, a contracting state may unilaterally terminate a treaty as of the beginning of the next calendar year by giving notice of termination to its treaty partner at least six months before the end of the current year. The contracting states may terminate a treaty at any time by mutual consent, although some treaties provide that a new treaty must remain in effect for a minimum period after it enters into force.

8.7.3 The Distributive Rules: Articles 6 through 21

8.7.3.1 Introduction

Articles 6 through 21 of the OECD and UN Model Treaties deal with the treatment of various types of income, from broad categories such as business profits to quite narrow categories such as directors' fees and pensions. This approach inevitably means that conflicts arise as to how amounts should be categorized for purposes of the treaty. These conflicts are sometimes resolved by definitions in the relevant articles. For example, Article 10(3) defines dividends as income from shares or other rights "not being debt-claims" and Article 11(3) defines interest as "income from debt-claims of every kind." Consequently, Articles 10 and 11 cannot both apply to the same amount - if an amount is income from a debt-claim, it is interest and cannot be a dividend. Sometimes the conflicts are resolved pursuant to specific provisions in the treaty. For example, where Article 7 and another article both apply, Article 7(4) of the OECD Model (Article 7(6) of the UN Model) gives priority to the other article. Some conflicts are not resolved by specific rules. Where an item of income is not covered by any of the specific articles (Articles 6-20), it is dealt with in Article 21 (Other Income).

The wording of the distributive rules of the OECD and UN Model Treaties is remarkably consistent. Where an article uses the words "shall be taxable only" in one of the contracting states, it means that the other state is precluded from taxing the relevant income. For example, under Article 8(1), profits from the operation of ships or aircraft in international traffic "shall be taxable only" in the country in which the enterprise has its place of effective management. In contrast, where the words "may be taxed" in a contracting state are used, it means that the relevant amount may be taxed by that country; however, it does not mean that the amount is not taxable by the other contracting state. In other words, the words "may be taxed" mean that the contracting states are both entitled to tax the relevant amount under the treaty. In these circumstances, the source country's tax takes priority and Article 23 requires the residence country to provide relief from double taxation by exempting the income from residence country tax or granting a credit for the source country tax against the residence country tax.

8.7.3.2 Business Income

The OECD and UN Model Treaties distinguish between several types of business income. For example, profits from immovable property, profits from international shipping and air transportation, and profits from entertainment and athletic activities are dealt with under Articles 6, 8, and 17 respectively. Article 7 of the OECD and UN Model Treaties applies to business profits that are not covered by a more specific article. Article 7 (Business Profits) provides that "an enterprise of a contracting state" is exempt from tax on its profits derived from business carried on in the other contracting state unless the business is carried on through a permanent establishment (PE) located in that other contracting state and the profits are attributable to the PE.

This limitation on a country's source jurisdiction is discussed in Chapter 2. The definition of a PE is provided in Article 5 (Permanent Establishment) and is discussed below. Article 3 (General Definitions) defines "an enterprise of a contracting state" as an enterprise carried on by a resident of a contracting state.

If an enterprise of a contracting state has a PE in the other contracting state, it is taxable by the other state only on the profits attributable to the PE. Article 7(2) of the OECD and UN Model Treaties provides that the profits of a PE should be determined on the assumption that the PE is a separate and distinct entity dealing independently with the other parts of the enterprise of which the PE is a part. The effect of these assumptions in Article 7(2) is that the transfer pricing rules applicable to associated enterprises under Article 9 also apply, by analogy, for the purpose of determining the profits attributable to a PE. The difficulties that arise in applying the arm's-length principle to determine the profits attributable to a PE are addressed in section 8.8.5 below.

Article 7 of the OECD Model Treaty does not use a so-called force-of-attraction approach, under which all of a taxpayer's income derived from a country is subject to tax by that country if it has a PE in that country. Under Article 7, if a taxpayer has a PE in a country, only the taxpayer's profits from the business that are attributable to the PE are subject to tax by that country. Other income may be taxable under other articles of the treaty, but not under Article 7.

Article 7(1) of the UN Model Treaty employs a limited force-of-attraction principle in determining the income attributable to a PE. Under that principle, if an enterprise has a PE in a contracting state, it is taxable by that state not only on the profits attributable to the PE, but also on profits derived from sales in that state of goods similar to those sold through the PE or from business activities in that state similar to the activities conducted through the PE. Although this limited force-of-attraction rule in the UN Model Treaty may appear to broaden the scope of Article 7 and reduce the opportunities for tax avoidance, the rule is easily avoided if profits unrelated to a PE are earned by a related nonresident entity.

The Definition of a Permanent Establishment

Under Article 5(1) of the OECD and UN Model Treaties, a PE is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." This language is used in essentially identical form in almost all tax treaties.

For an enterprise to have a "fixed place of business" in a contracting state, it must operate at a specific geographical location, and its activities at that location must continue for more than a temporary period (generally for more than six months). Thus, a taxpayer that does business at various locations in a country for an aggregate of more than six months does not have a fixed place of business PE in that country. The place where equipment, such as an oil pumping machine, is used can constitute a fixed place of business even if that machine is unattended by human agents of the enterprise. However, some countries take the position that human intervention is necessary for a place of business to constitute a PE.

For a place of business to be "fixed" in a geographical sense, it must have both geographical and commercial coherence. For example, a marketplace can be the fixed

place of business of an enterprise if the enterprise operates within that marketplace on a regular basis, even though it may use a different stall from time to time, because the marketplace has both geographical and commercial coherence. In contrast, if an interior designer provides services for a client in the client's office occupying a floor in a large office building for four months and then provides services for a different client with an office on a different floor in the same building for another four months, the office building cannot be considered to be the designer's PE. Although the building has geographical coherence (it is a fixed place), the offices where the designer works do not have commercial coherence because they are leased by different clients. Similarly, if the designer does work in two different buildings owned by the same person, those buildings are not the designer's PE, since the buildings do not have geographical coherence (they are different fixed places) although they do have commercial coherence. However, multiple buildings may have geographical coherence if they are part of a campus or office complex that constitutes a single location.

It is immaterial whether an enterprise rents or owns its premises in determining whether the premises constitute a PE, as long as the place is at its disposal (see paragraph 4 of the OECD Commentary). This concept of a place being at the taxpayer's disposal is problematic. It is clear that the taxpayer does need to have a legal right to use the place; on the other hand, it appears that the mere use of a place for more than six months is not sufficient to constitute a PE. For example, the OECD Commentary indicates that, if a salesperson employed by an enterprise visits a client's office every day to take orders, the client's office is not at the disposal of the enterprise and is not a PE of the enterprise. The OECD has proposed to amend the OECD Commentary to clarify that a taxpayer must have effective power over a place for it to be at the taxpayer's disposal (see OECD Discussion Draft, OECD, Discussion Draft, *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (OECD 2011), www.oecd.org/dataoecd/23/7/48836726.pdf) and OECD, *Revised Proposals concerning the Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (OECD 2012), available at www.oecd.org/ctp/treaties/PermanentEstablishment.pdf).

Both the OECD and UN Model Treaties provide that a building site or construction or installation project constitutes a PE if the project continues for at least twelve months in the case of the OECD Model Treaty (Article 5(3)) and six months in the case of the UN Model Treaty (Article 5(3)(a)). Both provisions apply to assembly and supervisory activities conducted in connection with a building or assembly site. These activities are explicitly included in Article 5(3)(a) of the UN Model Treaty, but not in the OECD Model Treaty, where they are dealt with in the Commentary (paragraphs 17 and 20 of the Commentary on Article 5).

Developing countries typically adopt the six-month period in the UN Model Treaty (or an even shorter minimum period for construction sites) in their tax treaties; for example, the minimum period in the India-US treaty is four months. A few treaties between developed countries extend the minimum period beyond one year. The Japan-US treaty, for example, has a twenty-four month period.

The construction site provisions in the OECD and UN Model Treaties are commonly misunderstood as deeming provisions. They are properly interpreted as an

additional condition that must be met in order for a construction site to constitute a PE. In other words, a construction site must satisfy the conditions of a fixed place of business under Article 5(1) and must also last for at least twelve months (OECD) or six months (UN). Thus, a project that involves construction activities at different locations in a country for an aggregate of more than twelve months is not a PE if the activities at each location do not last for at least twelve months. Each place at which construction occurs must be treated as a separate place unless the places have geographical and commercial coherence, as discussed above.

If the definition of a PE were limited to fixed places of business, it would be too narrow and would not apply to many types of businesses that do not need to be carried on through a fixed place of business. Consequently, both the OECD and UN Model Treaties extend the definition of a PE to include certain dependent agents acting on behalf of an enterprise. Under Article 5(5) of both Model Treaties, a resident of one contracting state is deemed to have a PE in the other contracting state if a person (often referred to as a dependent agent) has and habitually exercises on behalf of the resident an authority to conclude contracts that are binding on the resident. The agent must have not only legal authority to conclude contracts "in the name of the enterprise" but it must also do so habitually, which means regularly or repeatedly. The phrase "in the name of the enterprise" is not intended to have a literal meaning; it is sufficient if the contracts are legally binding on the enterprise.

The deemed PE rule in Article 5(5) does not apply if the person acting on behalf of an enterprise is an agent of independent status who is acting in the ordinary course of business (Article 5(6) of the OECD Model Treaty and Article 5(7) of the UN Model Treaty). Whether a person is an independent agent depends on all the facts and circumstances, although the Commentary on Article 5(6) of the OECD Model indicates that a person must be both legally and economically independent. Thus, an employee is invariably a dependent agent and a person who acts exclusively for one enterprise is likely to be considered a dependent agent in most circumstances.

The agency rule in the UN Model Treaty is more expansive than the OECD rule; it extends to dependent agents that habitually maintain a stock of goods from which they make deliveries on behalf of an enterprise. In addition, under Article 5(7) of the UN Model Treaty, an agent cannot be independent if the agent acts exclusively or almost exclusively for one enterprise and the commercial and financial relations between them are not at arm's length.

Many multinational corporations have used **commissionaire arrangements** to avoid having a PE in a country. A commissionaire arrangement is a legal relationship recognized under the civil law, under which one person enters into contracts in the name of or on behalf of another person, but those contracts are not legally binding on that other person. Therefore, multinational corporations can structure their affairs so that a group company in a low-tax country sells its products through another group company in a high-tax country to customers in that country as a commissionaire for the low-tax group company. The commissionaire does not own the goods and the contracts it enters into with customers are not legally binding on the group company that owns the goods. The result is that the group company acting as a commissionaire earns only a small profit from its activities; that profit is taxable in the high-tax country in which

it is resident. However, the group company in the low-tax country earns most of the profit from the sale of the products, and that company is not taxable in the high-tax country because it does not have a PE there.

Dell computers used this type of commissionaire arrangement to avoid tax in several high-tax European countries. A Dell group company established in Ireland sold computers to another group company established in Norway that resold the computers to customers in Norway. The Norwegian Supreme Court held that Dell Ireland did not have a PE in Norway (see *Dell Products v. The State*, December 2, 2011 *(Tax East)*, HR-2011-02245-A (Case No. 2011.755), Tax Treaty Case Law IBFD). The French Conseil d'Etat reached the same result in the Zimmer case, (see *Société Zimmer Limited*, March 31, 2010, Case No. 304715 and No. 308525, Tax Treaty Case Law IBFD.)

The OECD's revised discussion draft on BEPS Action 7: *Preventing the Artificial Avoidance of PE Status*, May 2015, available at www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf, proposes to amend Articles 5(5) and (6) to prevent the use of commissionaire arrangements to avoid PE status. Article 5(5) will be amended to deem an enterprise of one contracting state to have a PE in the other state if a person habitually concludes contracts or negotiates the material elements of contracts on behalf of the enterprise and if the contracts are in the name of the enterprise, for the transfer of the ownership or use of property owned or leased by the enterprise, or for the provision of services by the enterprise. Thus, a typical commissionaire arrangement would be covered by this provision because the commissionaire negotiates the material elements of the contracts for the sale of the goods owned by the principal even though those contracts are not legally binding on the principal. Article 5(6) will be amended to provide that a person who deals exclusively or almost exclusively with one or more enterprises with which it is connected will not be considered to be an independent agent. Thus, commissionaires will not be able to argue that they are independent agents.

The deemed agency PE rule in Article 5(5) of both Model Treaties does not apply if an agent's activities are limited to the exempt activities (generally preparatory or auxiliary activities) listed in Article 5(4), which is discussed below.

Under Article 5(6) of the UN Model Treaty, an enterprise engaged in the sale of insurance in a contracting state is deemed to have a PE in that state if it collects premiums in that state or ensures risks located in that state. This rule does not apply, however, if these activities are conducted by an independent agent acting in the ordinary course of business.

Article 5(3)(b) of the UN Model Treaty provides that an enterprise is deemed to have a PE in a contracting state if it performs services in that state through employees or other personnel for a period of at least 183 days in any twelve-month period with respect to the same or a connected project. Whether projects are connected must be determined based on all the facts and circumstances. The OECD Model Treaty has no comparable provision, although the OECD Commentary contains an alternative services PE provision that countries may adopt (see paragraph 42.23 of the OECD Commentary on Article 5).

Under the UN Model Treaty, income from the performance of independent personal services is taxable under Article 14 and not under Article 7. This approach was also followed under the OECD Model Treaty until 2000, when Article 14 was deleted. The taxation of independent personal services is discussed in section 8.7.3.3 below.

Article 5(4) of the OECD and UN Model Treaties provides an exemption from the definition of a PE for fixed places of business that are used exclusively for certain preparatory or auxiliary activities. Under both models, a fixed place of business of an enterprise used solely for the following activities is deemed not to be a PE:

- the storage or display of goods owned by the enterprise;
- the maintenance of a stock of goods owned by the enterprise for storage or display or for processing by another enterprise;
- purchasing goods or collecting information for the enterprise; and
- other activities of a preparatory or auxiliary character.

In addition, a fixed place of business used solely for a combination of the activities set out above is deemed not to be a PE as long as the overall activity is preparatory or auxiliary. Article 5(4) of the OECD Model also applies to a fixed place of business used solely for the delivery of goods owned by an enterprise. Therefore, if an enterprise owns or rents a warehouse in a country that it uses to store goods owned by it and to deliver those goods to customers, the warehouse would not be a PE of the enterprise. In contrast, under the UN Model Treaty, the warehouse would be a PE because delivery of goods is not an exempt activity. (Note that under both Model Treaties, if a warehouse is used to store goods owned by other enterprises, it will be a PE.)

The OECD's BEPS Action 7: *Preventing the Artificial Avoidance of PE Status* (October 31, 2014), available at www.oecd.org/ctp/treaties/action-7-pe-staus-public-discussion-draft.pdf proposes that Article 5(4) should be revised to ensure that the exemption in that article is available for the listed activities only if they are truly preparatory or auxiliary. Thus, a large warehouse owned by an enterprise and used to store goods that are sold through online shopping websites would be considered to be a PE. An alternative would be to delete the exemptions for delivery of goods, purchasing, and collecting information.

According to Article 5(7) of the OECD Model Treaty and Article 5(8) of the UN Model Treaty, a subsidiary resident in a country or carrying on business in a country does not constitute a PE of its parent company in that country simply because the parent controls it. Similarly, a parent company is not a PE of its subsidiary. Thus, a company resident in Country A that owns a subsidiary resident or carrying on business in Country B does not have a PE in Country B simply because it controls the subsidiary. However, the parent company might have a PE in Country B if its subsidiary habitually enters into contracts binding on its parent or if facilities owned or leased by the subsidiary are at the disposal of the parent company and used by it for more than six months. The Commentary on both the OECD and UN Model Treaties indicates that, with respect to a multinational group, the determination whether a PE exists must be

made separately for each company in the group; just because one group company has a PE in a country does not mean that any other group company has a PE in that country.

International Shipping and Air Transportation

Under Article 8 of the OECD Model Treaty and Article 8 (Alternative A) of the UN Model Treaty, business profits derived by an enterprise resident in one contracting state from the operation of ships or aircraft in international traffic are taxable exclusively by the state in which the enterprise has its place of effective management. Some treaties assign the exclusive right to tax to the country of residence of the enterprise in order to avoid uncertainty about the meaning of the place of effective management of an enterprise. The definition of "international traffic" (Article 3(1)(e)) for purposes of Article 8 is extremely broad and includes all transport other than transport of goods or persons solely between places in a country. Thus, Article 8 does not permit a country to tax the profits derived by an enterprise whose place of effective management is located in the other contracting state from taking goods or passengers on board in the country or unloading goods or passengers in the country. For example, an airline with its place of effective management in Country A that starts flights outside Country B, stops in Country B to drop off passengers and take on passengers, and completes the flights outside Country B would not be subject to tax by Country B. However, if the airline operates a flight that stops in Country B to pick up passengers and then stops at another location in Country B, Country B is allowed to tax the profits from the portion of the flight that takes place solely in Country B.

Article 8 (Alternative B) of the UN Model Treaty permits the source country to tax income derived from shipping (but not air transportation) activities if such activities are "more than casual." According to the Commentary, more than casual means any planned trip to a country to pick up goods or passengers.

Income from Entertainment and Athletic Activities

Under Article 17 of both the OECD and UN Model Treaties, income derived by an entertainer or athlete resident in one contracting state from entertainment or athletic activities performed in the other state are taxable in that other state without any threshold requirement or any limitations. Thus, a country is entitled to tax an entertainer or athlete who is present in the country for only a short period on the gross amount received by the entertainer or athlete without any limit on the rate of tax.

Article 17 provides a sharp contrast with Article 7, under which a source country is entitled to tax a nonresident on business profits only if the nonresident has a PE in the source country and only if the net profits are attributable to the PE. It is difficult to justify Article 17 on any principled basis. Some entertainers and athletes can make large sums of money in a relatively short time, and countries want their share of that money. However, other taxpayers, such as consultants and celebrities, who can also earn large sums in a relatively short time, are not subject to tax if they earn income in another country without any PE or fixed base in that country. Also, many entertainers and athletes earn only modest amounts from their entertainment and athletic activities; nevertheless, under the terms of Article 17, they are subject to tax without any limitations by the country in which their activities are exercised.

Article 17(2) contains an anti-avoidance rule that allows a country to tax income from entertainment or athletic activities occurring in the country even if the income is assigned by the entertainer or athlete to another person. For example, an entertainer might perform in a country as an employee of a personal services corporation so that most of the income from the performance is derived by the corporation rather than the entertainer. Article 17(2) allows the country to tax both the entertainer and the corporation.

Leasing income

Rental income derived from leasing equipment is taxable in accordance with Article 7 of the OECD Model Treaty. Therefore, such income is subject to tax by a country only if the taxpayer has a PE in the country and the income is attributable to the PE. Until 1992, such rental income was included in the definition of royalties for purposes of Article 12, so that the source country was precluded from taxing the income unless the taxpayer had a PE in the source country and the equipment was effectively connected with the PE (in which case Article 7 applied). However, Article 12 of the UN Model Treaty, which permits taxation of royalties by the source country, continues to treat income from equipment rentals as royalties. As a result, under the OECD Model Treaty, income from equipment leasing is not taxable by the source country unless the taxpayer has a PE in the source country and the income is attributable to the PE. In contrast, under the UN Model Treaty, income from equipment leasing is subject to tax by the source country at a limited rate on the gross rental payments under Article 12 even if the taxpayer does not have a PE in the source country. If the taxpayer does have a PE in the source country and the leasing equipment is effectively connected with the PE, then Article 7 applies.

Rent derived from immovable property situated in a country is taxable by that country in accordance with Article 6 of the OECD and UN Model Treaties irrespective of whether the rent is derived from a business or the taxpayer has a PE in that country. For example, income derived from renting an apartment building would be taxable in the contracting state where the building is located. Article 6 is discussed in section 8.7.3.4 below.

Many difficult issues arise in determining whether an enterprise has a PE in a contracting state as a result of engaging in electronic commerce in that State. Those issues are addressed in Chapter 9, section 9.6.

8.7.3.3 Employment and Personal Services Income

Many provisions of the OECD and UN Model Treaties deal with a wide variety of income from services. The provisions differ significantly, and therefore it is important to distinguish between the various types of services. For example, the basic rule for the taxation of income from employment is Article 15. However, some types of income from employment - such as income from entertainment and athletic activities, directors' fees, remuneration of top-level managerial officials, pensions, and income from government service - are subject to special rules.

It is frequently necessary to distinguish between employment income and independent personal services income in order to determine whether the rules for the treatment of employment income under Article 15, or the rules for the treatment of independent personal services income under Article 14 (or Article 7 of the UN Model Treaty) apply in a particular case. This distinction is important because the rules differ significantly. For example, an individual resident in one contracting state who is employed by an employer resident in the other contracting state is taxable by that other state on any income derived from employment exercised in that state. In contrast, if the individual is an independent contractor, the individual is taxable by the other contracting state only if the individual has a regularly available fixed base or PE in that state or stays in that state for more than 183 days.

Under Article 14 (Independent Personal Services) of the UN Model Treaty, a resident of a contracting state who performs "professional services or other activities of an independent nature" in the other contracting state is not taxable in that State unless he or she has a "fixed base" in the state that is regularly available or stays in the state for more than 183 days in any twelve-month period. The term "professional services" includes the services of physicians, lawyers, engineers, architects, dentists, and accountants, as well as independent scientific, literary, artistic, educational, and teaching activities. Article 14 was included in the OECD Model Treaty until it was removed in 2000. As a result of this change in the OECD Model Treaty, individuals and companies engaged in the performance of independent personal services in a contracting state are taxable in that state only if they have a PE in that state and their income is attributable to the PE.

The concept of a fixed base contained in Article 14 of the UN Model Treaty and the pre-2000 version of the OECD Model Treaty is intended to be equivalent to the concept of a fixed place of business in the definition of a PE in Article 5. However, the deemed agency PE rules and the exception for preparatory and auxiliary activities in Article 5 are not applicable in determining whether an enterprise has a fixed base for purposes of Article 14.

Income from employment performed in a country may be taxable in the country under Article 15 (Dependent Personal Services) of the OECD and UN Model Treaties whether or not the employee has a fixed base in the country. However, such income is exempt from tax in the source country if an employee is paid by a nonresident employer without a PE in the source country and the employee is present in the source country for not more than 183 days in any twelve-month period.

The limitations on source country taxation of professionals and employees do not generally apply to entertainers and athletes (see Article 17 of the OECD and UN Model Treaties). Nor do they apply to nonresidents receiving fees as corporate directors of resident corporations (see Article 16 of the OECD and UN Model Treaties) or remuneration as top-level managers of resident corporations (see Article 16 of the UN Model Treaty). Under Article 16, it is immaterial whether the income of the directors or top-level officials of a company arises from services performed in the contracting state in which the company is resident.

With certain exceptions, individuals performing employment services for the government of a contracting state are taxable only by that state (see Article 19 of the OECD and UN Model Treaties). Diplomats and consular officials who work in a foreign country as members of their government's diplomatic missions are exempt from tax under special agreements or under the rules of international law. A tax treaty would not affect such exemptions (see Article 27 of the OECD and UN Model Treaties).

Under Article 18 of the OECD Model Treaty, individuals receiving pensions on account of past employment are generally taxable only by the contracting state in which they are resident. In contrast, the UN Model Treaty provides some limited scope for taxation by the country where the payer of the pension is resident. Government pensions generally are taxable by the contracting state making the pension payment unless the individual receiving the pension is both a resident and a national of the other contracting state (see Article 19(2) of the OECD and UN Model Treaties).

Students and certain business apprentices or trainees who visit a contracting state for educational or training purposes are generally not taxable in that contracting state on payments for their maintenance, education, or training received from persons resident in the other state (see Article 20 of the OECD and UN Model Treaties). Some tax treaties also provide reciprocal exemptions for visiting professors and teachers.

8.7.3.4 Income and Gains from Immovable Property

Most countries want to retain the right to tax income derived from the sale and rental of immovable property and from the extraction of natural resources located within their territory. Reflecting this consensus view, Article 6 of the OECD and UN Model Treaties allows the country of source to tax income derived from "immovable property" situated in the country. The meaning of the term "immovable property" is determined in accordance with the law of the country in which the property is situated; the term includes income from agriculture, forestry, mineral deposits, and other natural resources. Article 13 of both Model Treaties allows gains from the disposition of immovable property to be taxed by the source country.

Because the source country is entitled to tax both the income derived from immovable property and gains from the disposition of such property, it does not generally matter for purposes of the Model Treaties whether a gain from the disposition of immovable property is characterized as income or capital gain; this characterization issue is left to domestic law. The same approach is used under the OECD and UN Model Treaties for income and gains from property other than immovable property.

Article 13(4) of the OECD and UN Model Treaties provides that a source country is entitled to tax gains from the disposition of shares of a company or an interest in a partnership or other entity if the value of the company, partnership, or other entity is derived primarily from immovable property situated in the country. That provision is intended to prevent a taxpayer from avoiding source country taxation on gains derived from immovable property by transferring the property to a controlled corporation, partnership, or other entity and then disposing of the interests in the corporation, partnership, or entity in a transaction that would otherwise be exempt from source

taxation under the tax treaty. Under Article 13(5) of the UN Model Treaty, the country in which a company is resident is entitled to tax gains from the disposal of a substantial interest in the company.

8.7.3.5 Reduced Withholding Rates on Certain Investment Income

A major objective of most tax treaties is to provide for reduced rates of withholding tax levied by the source country on dividends, interest, and royalties paid to residents of the other contracting state. The goal of these reduced rates is to provide for some sharing of the tax revenue between the source country and the residence country.

The OECD Model Treaty provides that the withholding taxes imposed by a source country will be limited to the rates shown in the table below.

Table 8.1 Maximum Withholding Rates Endorsed by OECD Model Treaty

	Dividends Paid to Corporations with a Substantial Interest	*Dividends Paid to Other Persons*	*Interest*	*Royalties*
Maximum Rate	5%	15%	10%	0%

Source: OECD Model Treaty, Article 10 (Dividends), Article 11 (Interest), and Article 12 (Royalties).

The maximum rates proposed in the OECD Model Treaty, especially the zero rate on royalties, are unacceptable to most developing countries and to many developed countries. The UN Model Treaty does not provide any specific limits on withholding rates, leaving those limits to be negotiated by the contracting states. Most tax treaties with developing countries allow maximum withholding rates that are substantially in excess of the rates provided in the OECD Model Treaty; it is uncommon, for example, for developing countries to agree to a maximum withholding rate on royalties of lower than 15 percent.

Many tax treaties provide for a more complicated set of maximum withholding rates than the simple pattern proposed in the OECD Model Treaty. For example, it is common for tax treaties to impose separate limitations on the withholding rates applicable to industrial royalties, royalties paid with respect to copyrights of literary works, and royalties paid for the showing of motion picture films.

The rules for the taxation of dividends, interest, and royalties under Articles 10, 11, and 12 of the OECD and UN Model Treaties respectively take priority over the rules for the taxation of business profits in Article 7. For example, under Article 11, interest paid by a resident of one contracting state to a resident of the other contracting state is taxable by the first state even if the interest forms part of the business profits of the resident of the other state. However, if the resident of the other state has a PE in the first state and the debt-claim in respect of which the interest is paid is effectively connected with the PE, the interest is taxable by the first state in accordance with Article 7 rather than Article 11 (see Articles 7(4) and 11(4) of the OECD Model Treaty and Articles 7(6)

and 11(4) of the UN Model Treaty). The rules in Articles 10(4), 11(4), and 12(4) of the OECD and UN Model Treaties are known as "throwback rules" because, in the first instance, Article 7 applies to dividends, interest, and royalties that constitute business profits; Article 7 then gives priority to Articles 10, 11, or 12, but those articles then make Article 7 applicable once again.

8.7.3.6 Other Types of Income

Most tax treaties do not impose limits on the rights of the contracting states to tax income, other than those types of income discussed above, derived by their residents. Article 13 of the OECD and UN Model Treaties generally provides that capital gains, other than gains from the disposal of the assets of a PE in the source country, immovable property situated in the source country, ships and aircraft used in international traffic, and interests in corporations, partnerships, and other entities the value of which is derived primarily from immovable property situated in the country, are taxable exclusively by the residence country.

The residual rule contained in Article 21 (Other Income) of the OECD Model Treaty similarly provides that items of income not dealt with in other articles of the treaty are taxable exclusively by the residence country. In contrast, Article 21 of the UN Model Treaty allows the source country to tax other income that arises in the source country. Article 21 of the OECD Model is important with respect to income derived from financial instruments. A tax treaty following the OECD Model Treaty precludes taxation at source of income items that may resemble various traditional types of income, but which are modified by contractual arrangements to constitute a type of income that is not mentioned in the treaty.

8.7.4 Administrative Cooperation

Several provisions in the OECD and UN Model Treaties are designed to promote administrative cooperation between the contracting states. Article 24 (Non-Discrimination) of the OECD and UN Model Treaties requires each contracting state not to discriminate unfairly against the residents and nationals of the other contracting state. Although nondiscrimination is a worthy objective, it is not easily attained. Issues arising under the nondiscrimination article are addressed in section 8.8.1 below.

Article 25 (Mutual Agreement Procedure) of the OECD and UN Model Treaties establishes a mechanism for resolving disputes that arise from the interaction of the tax systems of the contracting states or from the operation of the treaty itself. The mutual agreement procedure, including arbitration of tax disputes, is discussed in section 8.8.3 below.

Virtually all tax treaties provide for some cooperation between the contracting states in the administration of the tax treaty and their domestic tax systems. Article 26 (Exchange of Information) of the OECD and UN Model Treaties provides for the exchange of "such information as is foreseeably relevant for carrying out the provisions of this Convention or of the domestic laws of the contracting states concerning taxes

covered by the Convention." Article 27 (Assistance in the Collection of Taxes) is a recent addition to both the OECD Model and the UN Model Treaty, which provides for mutual assistance in the collection or enforcement of taxes. Exchange of information and mutual assistance are dealt with in section 8.8.4 below.

8.8 SPECIAL TREATY ISSUES

8.8.1 Nondiscrimination

In general, there are no significant legal restrictions on a country's jurisdiction to tax, and consequently, a country could consider taxing nonresidents more harshly than residents. In fact, however, most countries generally treat nonresidents in the same way as, or better than, residents for tax purposes. Probably the most important constraints on the unequal treatment of nonresidents are the possibility of retaliation by other countries and the need to attract investment by nonresidents.

The most important type of legal protection against discrimination for tax purposes is the nondiscrimination article of bilateral tax treaties. The nondiscrimination provisions of the GATT, the GATS, and other trade and investment treaties generally provide that tax discrimination is to be dealt with in accordance with bilateral tax treaties. Article 24 of the OECD and UN Model Treaties prohibits the contracting states from imposing tax consequences on the citizens or residents of the treaty partner that are less favorable or more adverse than the tax consequences imposed on their own citizens or residents. The treaties do not define discrimination or nondiscrimination. In general, however, discrimination means distinguishing between persons adversely on grounds that are unreasonable, irrelevant, or arbitrary. Conversely, nondiscrimination means equal (functionally equivalent) or neutral treatment. In any nondiscrimination case, the crucial issue is to determine the precise situations that are to be compared.

Article 24 of the OECD and UN Model Treaties prohibits discrimination against foreign nationals and nonresidents in several respects:

(1) Article 24(1) prohibits discrimination on the basis of nationality. Because most countries do not tax individuals on the basis of nationality (the US is a major exception), this provision is primarily important with respect to legal entities.
(2) Article 24(3) prohibits discrimination against nonresidents carrying on business in a country through a PE. Such nonresidents must be treated no less favorably than residents of the treaty country engaged in similar activities.
(3) Article 24(4) requires countries to allow the deduction of amounts paid by residents of a contracting state to residents of the other contracting state on the same basis as amounts paid to residents of the first state. In effect, this provision provides protection against discrimination indirectly because the direct beneficiaries of the legal protection are domestic enterprises. Thin

capitalization rules, which are discussed in Chapter 7, section 7.2, are widely considered to violate this aspect of a nondiscrimination article.

(4) Article 24(5) ensures that corporations, partnerships, and other entities resident in a contracting state whose capital is owned or controlled by residents of the other contracting state must be treated no less favorably than enterprises owned or controlled by residents. As with Article 24(4), the protection against discrimination is provided directly to resident entities and only indirectly to the nonresident owners of those entities.

Article 24 of the OECD and UN Model Treaties provides important but limited protection against tax discrimination. Some countries, such as Canada, refuse to treat nonresidents the same as residents (**national treatment**) for tax purposes. Instead, they agree in their tax treaties to provide **most-favored-nation treatment** to the residents of a particular treaty country. Most-favored-nation treatment ensures that the residents of a treaty country are treated the same as residents of other foreign countries. It does not guarantee that they will be treated the same or as well as resident taxpayers.

8.8.2 Treaty Abuse

8.8.2.1 Introduction

In general, tax treaties limit the taxes imposed by the contracting states. Not surprisingly, therefore, tax treaties have been widely used by taxpayers to avoid tax. This section examines the ways in which countries protect themselves from the abuse or improper use of their tax treaties. Section 8.8.2.2 deals with one particular aspect of treaty abuse, the problem of treaty shopping. Section 8.8.2.3 describes the OECD BEPS Action 6 proposals for dealing with treaty abuse.

As discussed in section 8.5 above, the two most obvious purposes of tax treaties based on the OECD and UN Model Treaties are the elimination of double taxation and the prevention of tax avoidance and evasion. Although the Model Treaties contain several explicit provisions aimed at eliminating or preventing double taxation, they have few provisions dealing with tax avoidance. Article 9 dealing with transfer pricing, Article 13(4) (allowing source countries to tax gains from the disposal of interests in land-rich enterprises), and Article 17(2) (allowing source countries to tax income from entertainment and athletic activities that accrue to a person other than the entertainer or athlete) are the only specific anti-abuse rules found in the Model Treaties. Nevertheless, the Commentary on Article 1 of both Model Treaties deals reasonably comprehensively with the topic of treaty abuse.

The Commentary on Article 1 of the OECD Model Treaty was revised in 2003 pursuant to the OECD's Harmful Tax Competition Project, which is described in Chapter 9, section 9.2.2. The 2003 Commentary states explicitly that "[I]t is also a purpose of tax conventions to prevent tax avoidance and evasion." Until that time, the only explicit statement found in the Treaty or the Commentary was that the purpose of tax treaties was to eliminate double taxation and prevent fiscal evasion (preventing tax

avoidance was not mentioned). Thus, taxpayers were able to argue that tax treaties could not be interpreted to prevent tax avoidance because there was no strong evidence that the prevention of tax avoidance was one of the purposes of tax treaties.

In addition, the 2003 Commentary on the OECD Model Treaty dealt with the interpretation of the provisions of tax treaties to prevent the granting of treaty benefits in abusive cases, and the relationship between domestic anti-avoidance rules and tax treaties. With respect to the first issue, the Commentary (paragraph 9.5) adopted, in effect, a general anti-abuse rule in the guise of the following "guiding principle":

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

With respect to the second issue, the Commentary (paragraph 22.1) indicates explicitly that domestic anti-avoidance rules are used to determine the underlying facts on which tax liability is based and, as such, they are not dealt with in tax treaties and are not affected by tax treaties. In general, therefore, there is no conflict between domestic anti-avoidance rules and the provisions of tax treaties, with the result that tax treaties do not prevent the application of domestic anti-avoidance rules.

Although the main points of the Commentary on Article 1 of the OECD Model Treaty are reasonably clear, as summarized above, that Commentary is somewhat disorganized and makes some distinctions between different types of domestic anti-avoidance rules, such as substance-over-form rules and CFC rules, that are difficult to justify. In contrast, the Commentary on Article 1 of the United Nations Model, which was revised as part of the 2011 update of that Model, provides a better organized and more comprehensive discussion of treaty abuse.

The UN Commentary on Article 1 (paragraph 10) identifies and discusses the following seven approaches for dealing with treaty abuse:

- specific anti-avoidance rules in domestic law;
- general anti-avoidance rules in domestic law;
- judicial anti-abuse rules;
- specific anti-avoidance rules in tax treaties;
- general anti-avoidance rules in tax treaties; and
- the interpretation of treaty provisions to prevent abuse.

The Commentary explains that, although tax treaties generally prevail over domestic law in the event of a conflict between them, conflicts between domestic anti-avoidance rules and tax treaties can often be avoided. Sometimes the provisions of the treaty (Article 9 with respect to transfer pricing is an example) may explicitly allow the application of domestic anti-avoidance rules; sometimes the treaty may depend on the application of domestic law, including domestic anti-avoidance rules; and sometimes the interpretation of the treaty will result in the denial of the benefits of the treaty consistent with the denial of such benefits under domestic anti-avoidance rules.

The UN Commentary on Article 1 also endorses the OECD guiding principle (quoted above) as to what constitutes an abuse of a treaty. Further, it indicates that, for countries that prefer not to rely on a non-binding statement of the guiding principle in the Commentary, the guiding principle could form the basis for a general anti-abuse rule to be included in the treaty. One difficulty with the inclusion of such a general anti-abuse rule is that it may create a negative implication that treaties without such a rule cannot be interpreted to prevent treaty abuse. This is particularly problematic for countries that have a large number of tax treaties because of the time needed to renegotiate all the treaties. The OECD BEPS project has proposed to deal with this difficulty through the negotiation of a multilateral treaty, which would amend existing bilateral treaties with respect to the BEPS recommendations for changes to the OECD Model Treaty. The OECD BEPS Action 6 proposals with respect to treaty abuse are discussed in section 8.8.2.3.

Finally, the UN Commentary on Article 1 provides several useful examples to illustrate the wide variety of potential treaty abuses and the rules necessary to deal with them.

8.8.2.2 Treaty Shopping

Only residents and (in some cases) nationals of a contracting state are entitled to benefits under an income tax treaty. Article 1 of the OECD and UN Model Treaties provides that a treaty applies to persons who are residents of one or both of the contracting states. Taxpayers who are not residents or nationals of a contracting state have frequently sought to obtain the benefits of a tax treaty by organizing a corporation or other legal entity in one of the contracting states to serve as a conduit for income earned in the other contracting state. This practice is commonly referred to as treaty shopping. Although a taxpayer may engage in treaty shopping to obtain any treaty benefit not otherwise available, most treaty shopping involves attempts by taxpayers to obtain reduced withholding rates on dividends, interest, and royalties. Treaty shopping is just one form of treaty abuse.

One classic form of treaty shopping involves the use of an unrelated financial intermediary located in a treaty country to make investments for taxpayers who are not themselves eligible for treaty benefits. For example, assume that T is a resident of Country TH, a tax haven jurisdiction that does not have a tax treaty with Country A. However, Country A has a tax treaty with Country B, under which Country A reduces its normal withholding tax rate from 30 percent to zero on interest paid to residents of Country B. T invests 1 million with BCo, an independent financial intermediary that is resident in Country B. BCo uses the 1 million to purchase a bond issued by ACo, an unrelated corporation resident in Country A. ACo pays BCo 100,000 of interest on the bond. BCo claims that the 100,000 is exempt from County A's withholding tax under the treaty with Country B. BCo pays 100,000 to T, minus some commission, as a return on T's original investment.

This example utilizes what is commonly referred to as a back-to-back arrangement to minimize taxes. BCo, the financial intermediary, avoids tax in Country A under

the tax treaty with Country B and avoids paying significant tax in Country B because the 100,000 of interest received from ACo is offset by the deduction of the amount paid to T.

Another classic form of treaty shopping involves the use of a controlled corporation organized in a treaty country. For example, assume that T, in the example above, organizes a wholly owned corporation, CCo; in Country C. T subscribes 2 million for shares of CCo, and CCo uses that money to purchase shares of stock in various companies resident in Country A and listed on Country A's stock exchange. CCo receives dividends of 400,000 on the shares. Country A has a tax treaty with Country C that reduces Country A's withholding tax on dividends paid to residents of Country C from 30 percent to 15 percent. As a resident of Country C, CCo claims the benefit of the treaty to reduce its tax otherwise payable on the 400,000 of dividends from 120,000 to 60,000. Assuming that CCo is exempt from tax in Country C because Country C does not tax foreign dividends under its domestic tax law, this simple type of treaty shopping results in a tax saving of 60,000.

The international tax community has been slow to take action to curtail treaty shopping. The OECD and UN Model Treaties do not contain any specific provisions designed to combat the types of treaty shopping abuses illustrated in the above examples. Indeed, some countries apparently have concluded that tolerance of treaty shopping is in their national interest. The US has been the leading proponent of aggressive international action to curtail treaty shopping. The problem of treaty shopping is exacerbated for countries, like the US, that enter into tax treaties with countries that have widely varying withholding rates because taxpayers have an incentive to take advantage of the most favorable treaty.

All recent tax treaties entered into by the US include a "**limitation-on-benefits**" *article* intended to curtail treaty shopping. The basic policy of the limitation-on-benefits article is to deny treaty benefits to a corporation that is resident in one of the contracting states, but is in effect serving as a conduit for residents of some third country. One way of thinking about a limitation-on-benefits provision is to consider it an attempt to limit treaty benefits to genuine residents of a contracting state.

The specific provisions of the limitation-on-benefits article contained in US tax treaties vary from treaty to treaty. However, the limitation-on-benefits provision in the US Model Treaty gives a good idea of the general US approach. In general, a corporation resident in a contracting state is not denied treaty benefits if it derives income from the active conduct of a trade or business (other than the business of making investments) in the other contracting state.

A corporation that fails to meet this active-business test must satisfy both of the following conditions to qualify for treaty benefits:

(1) the corporation's gross income must not be used in substantial part to pay interest, royalties, or other liabilities to persons not entitled to treaty benefits; and
(2) over 50 percent of the shares of the corporation (determined by reference to both the voting rights attached to the shares and the value of the shares) must

be owned, directly or indirectly, by certain qualified persons - typically, individuals who are residents of one of the contracting states.

The first of these conditions is intended to combat treaty shopping of the type illustrated in the first example above. The second condition addresses treaty shopping of the type illustrated in the second example.

The limitation-on-benefits article contained in US tax treaties is invariably more complex than the discussion above might suggest. Much of the complexity involves the definition of a qualified person. In general, the list of qualified persons includes individuals resident in a contracting state, US citizens, publicly traded companies (and certain of their subsidiaries), charitable foundations, and the contracting states themselves (including their political subdivisions and local authorities).

8.8.2.3 OECD BEPS Action 6: Preventing Treaty Abuse

The OECD issued a Discussion Draft on BEPS Action 6: *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* in March 2014 and a Revised Discussion Draft in May 2015. It is anticipated that the proposals will be finalized by the end of 2015 and the changes incorporated into the next update of the OECD Model Treaty. The Discussion Draft presents a comprehensive set of proposals to deal with treaty abuse, ranging from amendments to the title and preamble of the OECD Model to the addition of a general anti-abuse rule to the Model. Although the Commentary on Article 1 (paragraph 7) was revised in 2003 to establish that one of the purposes of tax treaties is to prevent tax avoidance, the OECD proposes to amend the title to the OECD Model Treaty to include specific references to the elimination of double taxation and the prevention of tax evasion and avoidance.

In addition to the revised title, the preamble to the OECD Model Treaty will include a statement that the intentions of the contracting states are to eliminate double taxation and prevent tax evasion and avoidance, including tax avoidance "through treaty shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States" (see section 8.5 above for the full preamble). The intention behind these changes to the title and preamble is to elevate the prevention of tax avoidance to a main purpose of tax treaties, along with the elimination of double taxation, so that national courts will take this purpose into account in interpreting the provisions of actual bilateral treaties that adopt the OECD recommendations.

The changes to the title and preamble will be reinforced by revisions to the Introduction to the OECD Model Treaty. Most importantly, the Introduction will state that the elimination of double taxation and the prevention of tax evasion and avoidance are the main purposes of the OECD Model Treaty. Currently, the Introduction indicates that the elimination of double taxation is the main purpose of the OECD Model Treaty.

The Discussion Draft makes a conceptual distinction between the circumvention of the provisions of a treaty itself and the use of a treaty to circumvent domestic law. The most obvious example of the first type of tax avoidance is treaty shopping. The

Discussion Draft proposes to deal with treaty shopping by including a new article (Entitlement to Treaty Benefits) containing a detailed US-style limitation-on-benefits provision (see section 8.8.2.2 above), supplemented by a general anti-abuse rule.

The detailed limitation-on-benefits provision denies treaty benefits based on the legal nature, ownership and control, and activities of a resident of a contracting state. The inclusion of a derivative benefits provision in the limitation on benefits is still under consideration. A derivative provision would allow an entity to qualify for treaty benefits to the extent that the owners of the interests in the entity would be entitled to equivalent or more favorable benefits if they received the payments or income directly.

Since the proposed limitation-on-benefits provision would not cover all transactions involving treaty shopping (e.g., conduit financing arrangements), the Discussion Draft recommends that a general anti-abuse rule should be added to the OECD Model Treaty as follows:

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

In effect, the guiding principle in paragraph 9.5 of the Commentary on Article 1, discussed in section 8.8.2.1 above, would be incorporated into the Model itself. The inclusion of such a general anti-abuse rule in actual bilateral tax treaties will have significant impact. Although the Commentary is considered to be of persuasive value, it is clearly not binding on domestic courts; however, a rule contained in the treaty itself cannot be easily ignored.

The proposed general anti-abuse rule consists of a two-part test. First, one of the main purposes of a transaction or arrangement must be to obtain treaty benefits and second, obtaining treaty benefits in the particular circumstances must be contrary to the object and purpose of the relevant provisions of the treaty. If the purpose test is met, the onus is on the taxpayer to establish that obtaining the treaty benefits would be in accordance with the purpose of the treaty.

The Discussion Draft also proposes to add several specific anti-abuse rules to the OECD Model Treaty, as follows:

- A holding-period requirement will be added for purposes of the application of the 5 percent tax rate on dividends in Article 10(2) and the taxation of capital gains from the alienation of shares in land-rich companies under Article 13(4). For the latter purpose, the alternative provision in the Commentary, which extends the provision to interests in other entities such as partnerships and trusts, will be incorporated into Article 13. The length of the holding period has yet to be determined.
- The tie-breaker rule for entities based on the place of effective management in Article 4(3) will be replaced by a determination by the competent authorities

on a case-by-case basis. If the competent authorities cannot agree, the entity will not be entitled to any treaty benefits.
- Treaty benefits will be denied with respect to income attributable to a permanent establishment (PE) in a third state. The type of rule that would be used to accomplish this result has not been decided. The Discussion Draft suggests a possible approach based on the rule in some US treaties, under which treaty benefits are denied where the income is subject to a preferential rate of tax (taking into account the taxes in both the residence country and the PE country) that is less than 60 percent of the corporate tax rate in the residence country.

The Discussion Draft proposes to clarify the Commentary on Article 1 with respect to the relationship between tax treaties and specific anti-avoidance rules in domestic law by adopting the approach used in the Commentary on Article 1 of the UN Model Treaty (2011). The OECD Commentary is confusing because portions of it were adopted at different times in response to different concerns. As discussed in section 8.8.2.1, the UN Commentary on Article 1 is much clearer than the OECD Commentary in this regard.

The final proposal in the Discussion Draft is the addition of a **saving clause** to the OECD Model to prevent residents of a country from relying on the provisions of a tax treaty to avoid residence country tax. The saving clause is a standard feature of US tax treaties and provides that, subject to certain exceptions, the treaty does not affect the taxation by a state of its own residents. The exceptions to the saving clause are the benefits provided under Articles 7(3), 9(2), 19, 20, 23, 24, 25, and 28.

The addition of a saving clause to the OECD Model is a good idea in principle because tax treaties are not generally intended to prevent a country from taxing its residents, and it will put other countries on the same footing as the US. Because of the saving clause, the US does not need to worry about applying its transfer pricing rules, CFC rules, or other anti-avoidance rules to its residents. In my view, it does not make sense for the US to be able to apply its domestic anti-avoidance rules without regard to its tax treaties, but not for other countries to do so, except to the extent permitted by the Commentary on Article 1, by specific provisions in their treaties, or by virtue of a treaty override.

In summary, the Discussion Draft presents a fairly comprehensive list of proposed changes to the OECD Model to deal with treaty abuse. The list is not completely comprehensive yet because it will be supplemented by other proposals stemming from other BEPS actions. For example, a new provision, Article 1(2), will be added to the OECD Model Treaty, indicating that income derived through a transparent entity will be considered to be income of a resident of a contracting state for purposes of the treaty only to the extent that it is treated as income of a resident of that state for purposes of taxation by that state.

It will take a long time for a country with numerous tax treaties to renegotiate all its treaties to include the proposed general anti-abuse rule and the other proposed changes. In the meantime, if the changes are included in only some of a country's tax treaties, a negative implication may arise that treaties without those provisions cannot

be interpreted to prevent treaty abuse. Therefore, the key issue with respect to the OECD proposals on treaty abuse is that their effectiveness depends on the conclusion of a multilateral treaty. Although the Discussion Draft on treaty abuse does not make any reference to BEPS Action 15: *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, if OECD member countries (and possibly other countries as well) can agree to a multilateral treaty that provides for the amendment of all their existing treaties to incorporate the changes aimed at preventing treaty abuse, the changes could be implemented relatively quickly.

Therefore, a multilateral treaty is critical to the effective implementation of the OECD proposals dealing with treaty abuse, but a multilateral tax treaty has been an elusive dream since the beginning. Negotiations for the multilateral treaty are planned to commence early in 2016.

8.8.3 Resolution of Disputes

Most tax treaties provide a mutual agreement procedure for resolving disputes that arise under the treaty. A person resident in a contracting state who believes that the actions of one or both contracting states will cause the payment of tax not in accordance with the treaty may request relief from the "competent authority" of the state of which the person is a resident. The competent authority is typically a senior official in the country's tax department who is responsible for international tax matters. The competent authority will make a determination whether the taxpayer's request appears justified and, if so, will attempt to provide an appropriate remedy. If the competent authority does not have the power to resolve a dispute on its own, it may attempt to resolve the dispute through consultations with the competent authority of the other contracting state.

The dispute-resolution mechanism of the OECD and UN Model Treaties is set forth in Article 25 (Mutual Agreement Procedure). This article provides that the competent authorities "shall endeavor" to resolve matters referred to them. Thus, it is notable that the competent authorities are not required to reach an agreement, even if the result is that a taxpayer is subject to double taxation. For this reason, mandatory arbitration was added to Article 25 of the OECD Model Treaty in 2008 for the resolution of issues that the competent authorities are unable to agree on within two years. Arbitration is discussed in Chapter 9, section 9.5.

Although a taxpayer is entitled to make its case to the competent authority of its country of residence, it is not allowed to participate directly in the consultative procedure between the competent authorities of the two contracting states. However, a few treaties contemplate that the taxpayer is entitled to present its case independently to both competent authorities.

A variety of disputes may be referred to the competent authorities. Some of these disputes involve the proper interpretation of treaty language, while others involve disputes over the facts on which a taxpayer's tax liability is based. The most common and complex disputes referred to the competent authorities involve the proper application of the arm's-length standard to transfer prices in cross-border transactions.

These disputes are sometimes difficult to resolve for a variety of reasons, including the large amounts of tax revenue frequently at stake. Article 9(2) of the OECD and UN Model Treaties provides that if one country adjusts the transfer prices used by related corporations in accordance with the arm's-length standard (and the other country agrees with the adjustment), the other country must make a corresponding adjustment to the profits of the related corporation in order to avoid double taxation. Transfer pricing is discussed in Chapter 6.

Under the domestic laws of many countries, multinational companies may request formal advance approval from the tax authorities of their methodology for establishing prices in their inter-group transactions. An administrative ruling entered into under this procedure is commonly referred to as an Advance Pricing Agreement (APA). In many situations, multinational enterprises prefer, if possible, to use the competent authority procedure to arrange for the joint issuance of an APA by several of the countries in which they do business.

8.8.4 Administrative Cooperation

The tax authorities of a country often experience difficulty in obtaining information concerning the foreign activities of residents and verifying that the information is correct. In the past, this difficulty was exacerbated by bank secrecy laws in many countries and the unwillingness of tax havens to exchange information with high-tax countries.

Article 26 (Exchange of Information) of the OECD and UN Model Treaties provides for an exchange of "such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration and enforcement of the domestic laws of the contracting states concerning taxes of every kind and description." Article 26 of the OECD Model Treaty was revised in 2005 to change the standard for exchanging information from "necessary" to "foreseeably relevant" and to require the exchange of information with respect to all taxes imposed by the contracting states, and not just the taxes covered by the treaty. These changes were intended to clarify the meaning of the Article, but not to change its substance.

Under the OECD and UN Model Treaties, an exchange of information may take place as a result of a specific request from a treaty partner, through an arrangement for an automatic exchange of information, or by the initiative of a contracting state acting spontaneously. Information requested by one state must be provided by the other state despite the fact that the information may not be necessary or relevant for the purposes of the other state's own taxes (i.e., the other state may have no domestic interest in the information).

Information obtained by the tax department of a contracting state under an exchange-of-information article must be kept confidential, although release of the information in court proceedings is generally allowed. Under the exchange-of-information article, a contracting state is not obligated to carry out administrative procedures on behalf of its treaty partner that are contrary to its own laws or practices, to supply information that is not obtainable under its domestic laws or in the normal

course of administration of both states, or that would result in the disclosure of trade secrets or similar information. An escape clause generally allows a contracting state not to provide requested information if its disclosure would be "contrary to public policy." However, under Article 26(5), a country cannot refuse to provide information solely because the information is held by a financial institution, a nominee or agent, or because it relates to ownership interests in a corporation or other person. Since most countries have been required to eliminate their bank secrecy laws, this provision is not as important as it would otherwise be.

Exchanges of information between tax authorities can take place only pursuant to international agreements between countries; therefore, in the absence of a bilateral tax treaty, it is usually impossible for the tax authorities to share information. Before this century, it was impossible for high-tax countries to get information from tax havens or low-tax countries with which they did not have a bilateral tax treaty. As a result, the practice developed for TIEAs to be concluded on a bilateral basis between OECD member countries and low-tax countries with which there was no need for a comprehensive income tax treaty. The US has been the leader in this regard; several OECD member countries have also concluded or are negotiating TIEAs with low-tax countries. TIEAs provide for countries to exchange information on a basis similar to Article 26 of the OECD Model Treaty.

As part of the OECD's Harmful Tax Competition Project in the late 1990s, the OECD proposed that tax havens should be required to obtain information about the beneficial ownership of companies and other entities formed under their laws and to require the companies to maintain financial accounts in accordance with generally accepted accounting standards and make those accounts available for the regulatory or tax authorities. In 2002, the OECD issued a *Model Agreement on Exchange of Information on Tax Matters*. Article 26 of the OECD Model Treaty was revised in 2005 to override any bank secrecy or other confidentiality laws of the country requested to provide information, and to delete the necessity for any domestic tax interest in the requested information. In 2011, Article 26 of the UN Model Treaty was revised to conform to Article 26 of the OECD Model, although Article 26 of the UN Model Treaty is broader in certain respects. For example, Article 26(1) includes the statement that information that is helpful in preventing tax avoidance or evasion shall be exchanged. In addition, Article 26(6), which authorizes the competent authorities to establish procedures for the exchange of information, has no counterpart in Article 26 of the OECD Model Treaty.

In 2001, the OECD established a Global Forum on Taxation to discuss exchange-of-information issues with non-member countries. This Global Forum, which is now known as the Global Forum on Transparency and Exchange of Information, has been very successful in ensuring that international standards for the exchange of information are implemented effectively. The Global Forum, which currently consists of 127 countries, engages in peer review exercises of both the legal and administrative capacity of countries to exchange information and of their actual performance in exchanging information. Countries are given ratings (which are available to the public) based on their compliance with the international standard for exchange of information.

Until recently, the international standard for exchanges of information between tax authorities has required only exchanges on request. In other words, one country was required to provide information only if the tax authorities of the other country specifically requested that information. However, in 2014 the OECD formulated a new *Standard for Automatic Exchange of Financial Information in Tax Matters*, (available at www.oecd.org) which provides for certain financial information (e.g., information about dividends, interest, proceeds of sale of financial products, and balances of certain accounts) obtained from a country's financial institutions to be provided automatically (i.e., without the necessity for a request by the tax authorities of another country) to the tax authorities of other countries on an annual basis. Over ninety countries have agreed to this new standard. In addition, over sixty countries have signed a *Multilateral Competent Authority Agreement* (available at ww.oecd.org) to implement automatic exchanges of information.

Often, the tax authorities of a country will audit the international affairs of taxpayers in addition to requesting information from other countries. Under international custom, however, the tax officials of one country cannot visit another country for the purpose of auditing a taxpayer's records unless invited to do so by the foreign government. Some governments consider it inappropriate for tax officials to make such visits without also obtaining the concurrence of the taxpayer. Several countries have addressed this problem by conducting joint audit programs, under which a particular taxpayer (and its affiliates) is audited by the tax authorities of both countries.

Once the tax authorities of a country have conducted an audit and assessed a tax deficiency against a taxpayer, they must collect any taxes owing. Tax authorities often encounter severe difficulties in enforcing tax liability in another country. Under the domestic law of most countries, the tax judgments of a foreign country generally are not enforceable, in accordance with the "revenue rule." Article 27 (Assistance in the Collection of Taxes) of the OECD and UN Model Treaties overcomes the limitations of the revenue rule by requiring each country to provide assistance in the collection of the other country's taxes. Like Articles 24 (Nondiscrimination) and 26 (Exchange of Information), Article 27 is not limited to the taxes covered by the tax treaty, but extends to all taxes imposed by the contracting states.

A request for assistance must be accepted by the requested state if the taxpayer cannot resist the collection of the taxes under the laws of the requesting state. In addition, the requested state must collect the taxes of the requesting state as if those taxes were its own. However, it is not required to provide assistance unless the requesting state has exhausted all the measures for the collection or conservancy of the taxes available under its domestic law and administrative practices, or the administrative burden to collect the taxes is disproportionate to the benefit to the requesting state. A taxpayer is not entitled to contest the existence, validity, or amount of the taxes owing in the courts or administrative bodies of the requested state. In providing assistance in the collection of the taxes owing to the other state, a state is not required to take any measures that are inconsistent with its own laws or administrative practices or contrary to public policy.

8.8.5 Attribution of Profits to Permanent Establishments

As discussed above in Chapter 5, section 5.8.1.2, an entity resident in one country may engage in substantial business activities in another country through a branch or PE in that country or through an entity (such as a subsidiary) established in that country. Unlike a subsidiary, a branch or PE is not a legal entity and cannot take actions on its own. The property and activities of a branch or PE are actually the property and activities of the entity of which it is a part.

When an enterprise resident in one country is engaged in business activities through a branch or PE in another country, it is necessary for both countries to determine the amount of income of the branch or PE. The source country requires this information in order to determine the amount of the nonresident enterprise's profits subject to source country tax. The country in which the enterprise is resident requires the information in order to provide relief from double taxation - by way of exemption or a foreign tax credit - of the profits earned by the enterprise through the foreign branch or PE. The domestic rules used by countries to compute the profits earned by a nonresident vary considerably, as discussed in Chapter 5, section 5.8.1.1.

Under Article 7(1) of both the OECD and UN Model Treaties, a resident of one country is taxable with respect to business profits by the other country only if it carries on business in the other country through a PE located in that country. Under the OECD Model Treaty, a resident carrying on business through a PE in the other country is taxable only on the profits attributable to the PE. Under the UN Model Treaty, such a resident is also taxable on profits from sales of goods similar to those sold through the PE and from other business activities similar to those carried out through the PE. This limited force-of-attraction rule in the UN Model Treaty is not very important because it is so easy to avoid.

Article 7(2) of both Model Treaties requires the profits attributable to a PE to be determined on the assumption that the PE is a separate enterprise dealing independently with the rest of the enterprise of which it is a part. (The rest of the enterprise means the head office of the enterprise and any other PEs of the enterprise.) This assumption is generally considered to make the transfer pricing rules of Article 9 applicable in determining the profits attributable to a PE.

Article 7 of the OECD Model Treaty was substantially revised in 2010 pursuant to a decade-long project, which culminated in 2008 with a report, *Attribution of Profits to Permanent Establishments*, and a new chapter dealing with PEs in the OECD's Transfer Pricing Guidelines. This new chapter was developed largely by economists working through Working Party 6, which did not take into account any of the constraints imposed by the wording of the existing Article 7 of the treaty. In effect, Working Party 6 took the separate-entity assumption in Article 7(2) to its logical conclusion; thus, a PE was required to be treated as a separate entity for all purposes in computing its profits. This new approach required a complete overhaul of the wording of Article 7.

Article 7(2) of the OECD Model Treaty was revised to provide that the profits attributable to a PE must be computed as if the PE were a separate entity "taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."

Paragraph 3 through 6 of Article 7, discussed below, were deleted and a new corresponding adjustment similar to Article 9(2) was added to Article 7(3). Article 7(3) requires a contracting state to make an adjustment to the profits of an enterprise if the other contracting state makes an adjustment in accordance with Article 7 to the profits of a PE of the enterprise in that other state.

The changes to Article 7 have been controversial. Seven OECD member countries have entered reservations on the new Article, indicating that they reject the new Article 7 and intend to adhere to the former version of the article. In addition, the UN Committee of Experts refused to adopt the OECD's new version of Article 7 in the 2011 revision of the UN Model Treaty.

Serious conceptual and practical difficulties arise in applying the transfer pricing rules to PEs, as described in Chapter 6. The transfer pricing rules in Article 9 apply to transactions between related persons. They do not apply to PEs because a PE is not a person; it is merely part of a legal enterprise, and transactions do not take place between parts of the same enterprise. As a legal matter, a transfer requires a change in ownership from one person to another, and a PE cannot own property. What is often described metaphorically as a transfer of property between the head office and a PE of an enterprise or between two PEs of the same enterprise is merely a change in the use or location of property owned by that corporation, and not a genuine transfer.

Therefore, in order to apply transfer pricing rules to PEs, it is necessary to treat a PE as if it were a separate legal entity and to construct some hypothetical transactions between the PE and the rest of the enterprise of which the PE is a part. Assume, for example, that ACo, resident in Country A, manufactures goods in Country A and sells those goods through a sales outlet in Country B. To apportion the income of ACo between the two countries by reference to the transfer pricing rules, ACo's sales activities through its PE in Country B would be treated as if they were carried on by a subsidiary corporation resident in Country B (e.g., BCo). ACo would be treated as if it had made a transfer of goods, either by sale or consignment, to the assumed BCo. The transfer pricing rules would then be applied to that notional transfer. An assumption would have to be made as to whether BCo was operating in Country B as an independent distributor or as an agent of ACo because the income earned by distributors and agents in the marketplace might not be the same.

Under Article 7(2) of the OECD Model Treaty, the determination of the profits attributable to a PE is a two-step process. The first step involves a functional and factual analysis of the PE in order to determine the functions performed by the PE, the economic ownership of assets by the PE, the risks assumed by the PE, the capital of the PE, and the hypothetical "dealings" between the PE and the other parts of the enterprise. The second step involves the application of the transfer pricing rules, by analogy, to those dealings in order to establish an arm's-length price.

Because of the necessity to invent dealings between a PE and another part of the enterprise, the application of the OECD's transfer pricing rules to PEs is even more difficult, uncertain, and less reliable than their application to transactions between associated enterprises. As noted above, several countries have rejected the OECD's new approach, and many countries will be unable to apply those rules effectively.

Most existing tax treaties contain a business-profits article that is similar to the former version of Article 7 of the OECD Model Treaty and the current version of Article 7 of the UN Model Treaty. As noted above, under Article 7(2), the profits of a PE are required to be computed on the assumption that a PE is a separate entity dealing independently with the rest of the enterprise of which it is a part. Thus, this version of Article 7(2) is not significantly different from the new OECD version of Article 7(2). However, the Commentary on the former version did not take the separate-entity assumption to its logical conclusion; instead, it provided a series of ad hoc practical rules for computing the profits attributable to a PE. Sometimes the Commentary required the PE to be treated as a separate entity; for example, if a PE transferred assets to the head office of the enterprise, the profits of the PE were computed as if the PE had sold the assets for their fair market value at the time of the transfer and the head office had acquired the assets for the same amount at the same time. In contrast, sometimes the Commentary rejected treating the PE as a separate entity; for example, notional payments of interest or royalties were not deductible in computing the profits of a PE under the former version of Article 7 (except in the case of financial institutions), whereas they are deductible under the new OECD Article 7.

Consider the following example, which illustrates the different approaches under the two versions of Article 7. ACo is an enterprise resident in Country A that commences to carry on business through a PE in Country B. ACo borrows 200,000 with interest at 10 percent, which it transfers to the PE to finance the establishment of the business carried on in Country B. ACo also advances an additional 1 million to the PE to finance the PE's business. Under the new Article 7, it would be necessary to determine how much debt and equity a separate entity would have if it performed the functions of the PE, owned the assets of the PE, and assumed the risks of the PE. Thus, if such a separate entity would have debt equal to twice its equity, the PE would be assumed to have 400,000 of equity and 800,000 of debt; thus, interest at 10 percent (assuming that 10 percent is an arm's-length interest rate) would be deductible in computing the profits attributable to the PE. In contrast, under the former version of Article 7 of the OECD Model Treaty and the current version of Article 7 of the UN Model Treaty (see Article 7(3), which explicitly denies any deduction for notional payments of interest or royalties), only interest on 200,000 (the actual interest expense incurred by the ACo in respect of debt used for the purposes of the PE) would be deductible in computing the profits of the PE.

Allowing the deduction of notional payments of interest and royalties is problematic. Where actual payments of interest and royalties are made and those payments are deductible in computing the profits of a PE, under Article 11 or 12 of the Model Treaties, the source country is entitled to impose withholding tax on the payments. However, notional payments of interest and royalties are not subject to source country withholding tax.

International banks, insurance companies, and other financial services companies often operate their global businesses through branches. Often the reason for using a branch is to satisfy capital reserve requirements imposed in many countries to protect investors and customers. Under the Commentary on former Article 7(3) of the OECD Model Treaty (paragraph 49) and the Commentary on Article 7 (3) of the UN Model

Treaty (paragraph 41), a financial institution is allowed to deduct notional interest payments in computing the profits of a PE. According to the Commentary, the special treatment of banks and other financial institutions is appropriate "in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises."

Article 7(3) of the UN Model Treaty (and former Article 7(3) of the OECD Model Treaty) provides that expenses incurred by an enterprise for the purposes of a PE must be allowed as deductions in computing the profits of the PE irrespective of where the expenses are incurred and whether they are incurred wholly on behalf of the PE. Thus, the PE country cannot deny the deduction of expenses because they are incurred outside the source country or because only a portion of the expenses relates to the PE. For example, head office expenses, such as accounting and legal expenses, which are incurred by the head office on behalf of a PE, must be allowed as deductions in computing the profits of the PE. However, it must be emphasized that the deductibility of expenses is a matter for domestic law. Therefore, for example, if only a portion of entertainment expenses is deductible under the domestic law of the source country, the source country is not required by Article 7 to allow the full amount to be deductible in computing the profits of the PE.

Article 7(4) of the UN Model Treaty (and former Article 7(4) of the OECD Model Treaty) provides that the profits of a PE may be computed in accordance with a formulary apportionment of the profits of the enterprise as a whole as long as that has been the customary practice of the country in which the PE is located. However, any such formulary apportionment must produce a result that is consistent with the principles of Article 7; in other words, it must be consistent with the profits that the PE would be expected to make if it were a separate entity.

Article 7(5) of the UN Model Treaty (and former Article 7(5) of the OECD Model Treaty) provides that the profits of a PE must be determined on a consistent basis from year to year unless there is some good and sufficient justification for a change in the method for computing PE profits.

No country has developed detailed and comprehensive domestic rules for extending transfer pricing rules to branches. In practice, most countries compute the profits of a PE on the basis of the profits shown in the taxpayer's books of account and make ad hoc adjustments if those books do not produce a reasonable result. However, since the books and records of a PE are within the control of the enterprise, they may not be reliable, and the tax authorities must scrutinize them carefully to ensure that they accurately reflect the profits of the PE.

CHAPTER 9
Emerging Issues

9.1 INTRODUCTION

This chapter deals with several important recent developments in international tax. Although many of these developments have been mentioned in previous chapters, they are dealt with in detail here for convenience. There is no overarching theme to the topics dealt with in this chapter other than the fact that they have become increasingly important in recent years.

The issues discussed in this chapter are wide-ranging. They include international aspects of domestic law and tax treaties, substantive issues, and administrative issues such as exchange of information and arbitration.

The prominence of the issues discussed here is largely attributable to the work of the OECD and the United Nations (UN). The OECD has become a dominant player with respect to international tax issues, as the recent G-20/OECD BEPS project shows. In recent years, the UN, through the Committee of Experts and its Capacity Development Unit, has also started to exert an increasingly important influence in the international tax arena. For example, the proposal to add a new article to the UN Model Treaty dealing with fees for technical services, discussed in section 9.4 below, represents a potentially important step in the evolution of tax treaties.

9.2 BASE EROSION AND PROFIT SHIFTING (BEPS)

9.2.1 Introduction

Since 2012, the OECD's BEPS project has dominated the international tax agenda. As discussed below in section 9.2.3, the scope of the project is huge, comprising fifteen action items, and the time frame for its completion – the end of 2015 – is unrealistically tight. The project involves not only OECD member countries, but also G20 and developing countries. Many of the action items are discussed elsewhere in this Primer.

This section presents an overview of the BEPS project and its implications for the international tax system. It is important to understand that the problems with the international tax system targeted by the BEPS project are not new. Many of them involve fundamental structural features of the allocation of taxing rights between source and residence countries that countries and international organizations, such as the OECD and the UN, have struggled with for decades. As background for understanding the BEPS project, section 9.2.2 discusses the OECD's first attempt to deal with some of the fundamental problems of the international tax system - the harmful tax competition initiative of the late 1990s.

9.2.2 The 1998 OECD Harmful Tax Competition Report

Over the last fifty years, the proliferation and increased use of tax havens and preferential regimes in otherwise high-tax countries has been staggering. Many developments have contributed to this phenomenon, including:

- the elimination of exchange controls and the liberalization of cross-border trade and investment;
- improved communications, transportation, and financial services;
- the globalization of tax advisory firms;
- the adoption of flexible commercial regimes and strict bank secrecy and confidentiality requirements by tax havens; and
- aggressive marketing.

Tax havens and countries with preferential regimes have become very sophisticated in marketing their services to every geographical region of the world and to every conceivable tax planning need. Although the competition among them is fierce, the field remains crowded, with newer havens and regimes continually being introduced to try to get a piece of the action.

This proliferation of low-tax regimes and their base-eroding effects are what the OECD has called a "race to the bottom." Concern about this race to the bottom led to the OECD and European Union (EU) initiatives against harmful tax competition in the late 1990s. After years of work and difficult negotiations, the OECD issued a *Report on Harmful Tax Competition* in April 1998. The EU adopted a Code of Conduct concerning harmful tax competition in December 1997 (Commission of the European Communities, *A Package to Tackle Harmful Tax Competition in the European Union).* Although the two initiatives were complementary, the EU Code of Conduct was considerably broader than the OECD Report because it was not limited to geographically mobile activities (the OECD Report was limited to geographically mobile activities, including financial services). The Report recognized that harmful tax competition also occurs with respect to non-mobile activities, such as manufacturing and personal savings, but these activities were left for future action because they were considered more difficult to deal with.

Although the OECD Report was targeted at "harmful tax competition," no definition of that expression was provided in the Report. This shortcoming was

understandable because the term is impossible to define precisely. The use of the term "competition" was perhaps unfortunate because in an era of global free trade and capitalism, it was an article of faith that all competition is good. However, the essential concept inherent in the term "harmful tax competition" is that there is a difference between the type of tax competition that led to a worldwide lowering of tax rates and broadening of tax bases in the late 1980s, and harmful tax competition, which involves the race to the bottom described earlier. According to the OECD, although every country has the sovereign right to determine its own tax policy, a country should not enact policies intended to "poach" the tax base of other countries.

The OECD Report targeted both tax havens and harmful preferential tax regimes, including such regimes in the tax systems of OECD member countries. The Report also suggested a lengthy list of countermeasures that countries might take on both a unilateral and a coordinated basis to deal with tax havens and low-tax regimes. However, the OECD soon abandoned the idea of sanctions against tax havens in favor of a strategy of dialogue and cooperation.

The harmful tax competition initiative was significant because it signaled the beginning of serious international cooperation in fighting tax evasion and avoidance. However, the OECD's action was very controversial. It was accused by some commentators and several smaller tax haven countries of being a cartel of rich countries dictating to small, underdeveloped countries, and of trying to impose a particular type of tax system - an income tax - and a minimum rate of tax. Other commentators, however, have welcomed the OECD initiative as the next logical step for countries to take to protect their domestic tax bases.

Any major new tax policy initiative is a political issue, and the harmful tax competition project was no exception. In late 2000, the United States (US), which until that time had been an enthusiastic supporter of the harmful tax competition project, effectively compelled the OECD to refocus the project almost exclusively on exchange of information. As a result, the OECD committed to developing standardized exchange-of-information provisions in both bilateral and multilateral formats, dealing with both criminal and civil tax matters; its efforts have resulted in a much more effective and efficient system with respect to exchange of information. Exchange of information is discussed in Chapter 8, section 8.8.4.

Although the original goal of the OECD's project was changed from eliminating harmful tax competition to the more modest goal of effective exchange of information, the project has produced some significant results. For example, the Commentary on Article 1 of the OECD Model Treaty was revised extensively in 2001 to clarify the relationship between tax treaties and domestic anti-avoidance rules. This issue is discussed in Chapter 8, section 8.8.2. Also, some of the most obvious preferential tax regimes in OECD member countries have been eliminated.

9.2.3 The G20/ BEPS Project

In retrospect, it was only a question of time before pressures on countries' tax revenues led to additional efforts to protect their domestic tax bases from the tax planning

strategies of multinational enterprises; these efforts gained momentum during the financial crisis of 2008. In 2012, the OECD launched its project against BEPS. The project received a shot in the arm when aggressive tax-planning techniques used by several US multinationals, including Apple, Amazon, Starbucks, and Google, came under intense criticism by European and American politicians.

The BEPS initiative was a natural outgrowth of the OECD's work on exchange of information as a tool to combat international tax avoidance, although the impetus for the project was the final declaration of the meeting of the G20 finance ministers in June 2012, which emphasized "the need to prevent base erosion and profit shifting." In February 2013, the OECD responded to the G20's concerns by issuing a short note, "Addressing Base Erosion and Profit Shifting," that identified several areas for action and deadlines for the implementation of responses. The G20 finance ministers meeting in February 2013 welcomed the OECD report and strongly supported the initiative in the following terms:

> We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July.

On July 19, 2013 the OECD released a detailed *Action Plan on Base Erosion and Profit Shifting* (OECD Action Plan). This Action Plan sets out an ambitious agenda with tight deadlines; it consists of the following actions:

(1) Develop rules to allow countries to impose direct and indirect taxation on electronic commerce (the digital economy) (electronic commerce is dealt with in section 9.6).
(2) Develop treaty provisions and recommendations for domestic rules to deal with hybrid mismatch arrangements involving the use of hybrid entities and hybrid financial instruments (the BEPS proposals with respect to hybrid entities and hybrid financial instruments are discussed in section 9.3).
(3) Develop proposals to strengthen controlled foreign corporation rules (the BEPS proposals with respect to CFC rules are discussed in Chapter 7, section 7.3).
(4) Develop recommendations to deal with base erosion through interest and other financing expenses (the BEPS proposals with respect to interest deductions are discussed in Chapter 7, section 7.2).
(5) Develop more effective countermeasures for harmful tax practices.
(6) Develop treaty anti-abuse provisions and recommendations for the adoption of domestic anti-abuse rules (the BEPS proposals with respect to treaty abuse, including treaty shopping, are discussed in Chapter 8, section 8.8.2.3).
(7) Revise the definition of permanent establishment (PE) in the OECD Model Treaty to prevent the use of commissionaire and other arrangements to avoid PE status (the BEPS proposals with respect to the definition of a PE are discussed in Chapter 8, section 8.7.3.2).

(8) Revise transfer pricing rules to ensure that transfer pricing cannot be used for base erosion and profit-shifting purposes (the BEPS proposals with respect to transfer pricing are discussed in Chapter 6).
(9) Develop methodologies for the collection and analysis of data concerning BEPS and for the evaluation of the effectiveness of measures to counteract BEPS.
(10) Develop measures to require the disclosure of aggressive tax planning arrangements.
(11) Improve transfer pricing documentation (see Chapter 6, section 6.8).
(12) Improve the treaty process for the resolution of disputes, including arbitration (the resolution of tax disputes is discussed in Chapter 8, section 8.8.3, and arbitration is discussed below in section 9.5).
(13) Develop a multilateral treaty to implement BEPS countermeasures and to amend bilateral treaties (the multilateral treaty is discussed in Chapter 8, section 8.8.2.3).

The OECD's BEPS Action Plan is obviously an ambitious one, even taking into account the fact that the OECD had been working on some of the issues, such as hybrid mismatch arrangements and transfer pricing, before the announcement of the BEPS project. It is even more ambitious considering the timeframe for the delivery of the OECD's recommendations. Only the work on the transfer pricing aspects of financial instruments, part of the work on harmful tax practices, and the development of a multilateral treaty was scheduled to take more than two years. With respect to the other issues, OECD recommendations were due to be completed by September 2014 or September 2015. The OECD has adhered to this timetable, although it has acknowledged that work on many of the issues will necessarily continue after 2015. The tight timing of the BEPS project emphasizes the importance of the work to the OECD and the G20; however, it also raises some concerns about the quality of the work produced under such tight time constraints.

At this stage, several general comments about the BEPS project seem appropriate. First, the project has gained widespread support from the G20, which includes Brazil, Russia, India, China, and South Africa (the so-called BRICS), as well as from developing countries. The work is supported by the UN, the World Bank, and the International Monetary Fund. One crucial question is whether the widespread support for the BEPS project in principle will continue when the project calls for coordinated action by these nations on specific issues.

Second, coordinated action by the member countries of the OECD, the BRICS, and developing countries is essential for the success of any action to combat aggressive tax planning by multinational enterprises, since multinationals operate and engage in tax planning on a worldwide basis. Unilateral action by countries, even countries with the largest economies, such as the US, is likely either to prove ineffective or to inflict serious damage on the domestic economy.

Third, the bad publicity generated by the attacks of politicians in Europe and the US against multinationals has generated a public perception that multinational corporations are engaged in tax avoidance activities that are probably illegal, and certainly immoral - multinationals appear to have been put on the defensive.

Fourth, the problems of BEPS - (incidentally, the terms "base erosion" and "profit shifting" are synonyms; they do not describe different problems) - are not new. International tax planning has been a standard part of business practice for decades, and inevitably, governments have responded with various types of rules to protect their tax bases. Therefore, it is important to see the current situation as just the most recent manifestation of the tension between multinational corporations and national tax authorities. In the past, however, tax authorities responded to international tax avoidance primarily with unilateral anti-avoidance measures in their domestic law or in their bilateral tax treaties. In contrast, multinational enterprises engage in tax planning on a worldwide basis.

As noted above, any effective response to the problem of international tax avoidance requires coordinated action by national tax authorities. It remains to be seen whether such coordinated action is feasible. On the one hand, the failure of the OECD's previous attempt to deal with harmful tax competition and the inability of countries to see beyond their narrow self-interest makes one skeptical about the BEPS project. On the other hand, the support of the G20 and the apparent success of the OECD-led efforts to improve exchange of tax information among all countries, including tax havens, suggests that the situation may be different today.

Finally, the BEPS project represents an opportunity to take some tentative first steps to redesign an international tax regime that has become a bit tired. Thus, the BEPS project should be viewed as simply the most recent and most ambitious episode in a long-term effort to make the international tax system less vulnerable to international tax planning by multinational enterprises. Even if only a few of the BEPS action items are successfully implemented, the effects will be significant.

The tax policy considerations underlying the OECD's BEPS initiative are superficially clear. Aggressive international tax avoidance by multinational enterprises has several harmful consequences for national tax systems:

(1) It reduces government tax revenues and increases the cost to governments of ensuring compliance by multinational enterprises with the tax rules.
(2) It undermines the perceived integrity of the tax system and may have a deleterious effect on tax compliance generally.
(3) It undermines the fairness of national tax systems because taxpayers other than multinational corporations must bear a greater share of the tax burden.
(4) Small- and medium-sized enterprises may not be able to take advantage of the same international tax planning opportunities as multinational enterprises and may therefore be placed at a competitive disadvantage.
(5) Finally, distortions in the location of investment may result to the extent that opportunities for aggressive tax planning are greater in the international context than in the domestic context.

However, the tax policy analysis of BEPS for any particular country is much more subtle and difficult than the foregoing list of consequences may suggest. The tax systems of many capital-exporting countries contain features designed to facilitate the international competitiveness of their resident multinational corporations. Over the past two or three decades, these countries have consistently taken domestic measures to enhance the competitive position of their resident multinational corporations, or at the least have avoided taking measures that would place their multinationals at a competitive disadvantage. Thus, many countries seem likely to have a two-faced attitude to BEPS. On the one hand, they want to protect their domestic tax bases from the aggressive tax-planning strategies of foreign-based multinationals. On the other hand, they have no interest in preventing their own resident multinationals from eroding the tax base of other countries (i.e., making them pay more foreign tax).

From any particular country's perspective, therefore, the ideal result from the BEPS project would be that other countries take action to require their multinational corporations to pay more foreign tax, while it does little or nothing with respect to its resident multinationals so that they gain a competitive advantage. In simple terms, this explains why coordinated action is so important and so difficult. Part of the difficulty relates to the widely varying interests of OECD member countries. For example, net capital-importing countries have different interests from net capital-exporting countries. In addition, some OECD members, such as Belgium, Ireland, Luxembourg, and the Netherlands, have significant interests both from a public perspective (tax revenue, investment, employment) and a private-sector perspective (professional firms and financial institutions) in facilitating international tax planning by multinational enterprises, and therefore have an interest in maintaining the status quo.

9.3 HYBRID ARRANGEMENTS

9.3.1 What Is a Hybrid Arrangement?

The term "hybrid arrangement" is generally used to describe situations in which two countries take different and inconsistent positions with respect to the tax treatment of some aspect of an arrangement. This inconsistent treatment may result in either beneficial or harmful consequences for a taxpayer. For example, inconsistent positions on transfer prices may result in double taxation, whereas inconsistent positions on the character of certain payments may result in a deduction in one country and no taxation in the other country. Of course, well-advised taxpayers, such as multinational corporations, will plan to avoid the harmful consequences of hybrid arrangements and use them to generate tax benefits.

Hybrid arrangements, as broadly defined above, include all the fundamental features of an income tax system: the persons subject to tax, the type of activities giving rise to income (employment, business, and investment), and the types of payments relevant for the computation of net income. However, the most important types of hybrid arrangements are hybrid entities and hybrid financial instruments.

Hybrid arrangements are often used as substitutes for tax planning arrangements involving tax haven entities. For example, tax haven entities are often used as intermediaries to receive deductible payments from an entity in a high-tax source country and then pay those amounts in a non-taxable form to a related entity in a high-tax residence country. A hybrid arrangement can achieve the same result without the use of a tax haven. For example, if an entity in a high-tax source country, HE (the hybrid entity) is treated as a flow-through or transparent entity, that country may treat deductible payments to HE as payments made to the owner of the entity, ACo, which might be resident in a high-tax country. The payments to HE might be exempt from source country tax, either under its domestic law or under the provisions of a tax treaty. The payments also might not be taxable by the residence country because it treats HE as a separate taxable entity. Therefore, as far as the residence country is concerned, the payments are not received by ACo.

9.3.2 Hybrid Entities

A hybrid entity is a legal relationship that is treated as a separate taxable entity in one jurisdiction and as a transparent or flow-through entity in another jurisdiction. For example, under the laws of Country A, it may be possible to establish a form of business organization in which the members own interests and have limited liability. Country A may treat this organization as a partnership for tax purposes, with the result that the members or partners are taxable on their shares of the income of the organization. On the other hand, under the tax laws of Country B, the organization may be characterized as a corporation - as a legal entity separate from its members or shareholders - with the result that the organization itself is subject to tax on its income. Accordingly, if one or more of the members of the organization is resident in Country B, the different treatment of the organization in the two countries creates many tax planning opportunities.

Hybrid entities may take many different shapes and forms. Whether or not a particular entity is a hybrid entity depends on the domestic laws of the countries involved and, in particular, how they characterize entities for tax purposes. For example, trusts and other similar fiduciary relationships may be hybrids because they are treated as entities by some common law countries but are ignored by some civil law countries. Hybrid entities may also include special entities or arrangements, such as corporations limited by guarantee, that are recognized under the laws of some tax havens. The "owners" of the value of the company (the guarantors) have rights and obligations pursuant to a contract, but have no rights to vote or receive dividends. The shares of the company are owned by shareholders who have the right to elect the directors but only limited rights to receive dividends. Dividends can be paid to persons who have no relationship with the company (i.e., persons related to the guarantor). The shareholders are typically trust companies that provide wealth management and estate planning services. Several tax havens have enacted legislation allowing the establishment of these types of entities, which have many of the characteristics of *inter vivos* trusts.

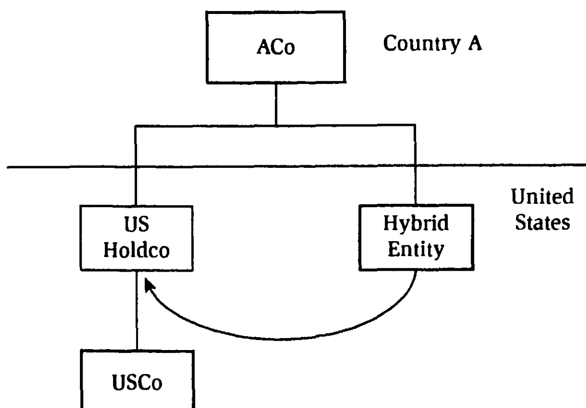
Several countries recognize silent partnerships, which are essentially contractual arrangements. The silent partners contribute assets to a managing partner in consideration for a share of the profits from a business. Silent partnerships are not treated as entities; the managing partner owns the assets transferred by the silent partners. The payments made to the silent partners are usually deductible in computing the income of the managing partner, although they may be subject to withholding tax. If the country in which a silent partner is resident treats the silent partnership as a partnership, and if it taxes business income on a territorial basis, then there will be no tax, except possibly withholding tax, in either country.

In a 1998 case in the United Kingdom, *Memec PLC v. IRC* [1998] STC 754 (Court of Appeal), Memec, a UK company, owned shares of a German company, which in turn owned shares of two German operating companies. The operating companies paid German trade taxes that were not creditable against UK tax when Memec received dividends from its top-tier German subsidiary. Therefore, Memec entered into a silent partnership with the German corporation and then claimed that it had received dividends as a partner directly from the operating companies, so that the trade taxes were creditable. The UK Court of Appeal held that the German silent partnership was not a partnership under UK law and that the source of the income was the contractual arrangements.

In the last fifteen to twenty years, tax planning opportunities through the use of hybrid entities have proliferated as a result of the US **check-the-box rules**. Before 1997, entities were classified as corporations or partnerships under US tax law based on six factors, including limited liability, continuity of life, centralized management, and free transferability of interests; tax planners were able to manipulate these factors to achieve the desired status for an entity. For example, the use of limited liability companies (LLCs) as transparent investment vehicles became very popular. LLCs were created under special state statutes as vehicles for tax shelters, providing limited liability for investors but treated as transparent for US tax purposes.

In 1997, the US government adopted check-the-box rules, which made the classification of many business entities elective for taxpayers. Instead of manipulating the six factors to achieve the desired characterization, taxpayers can simply elect to have an entity treated as a corporation, a partnership, or a disregarded entity (if the entity has only one member) by checking a box on a prescribed form. A disregarded entity is treated as a sole proprietorship if the single owner is an individual, or as a branch if the single owner is a corporation. The election can be made with respect to LLCs, partnerships, joint ventures, branches, and other business entities, and it can be made with respect to entities created under foreign laws. Once made, an election cannot be altered for five years. The election cannot be made for certain entities that are clearly corporations (so-called per se corporations).

The US check-the-box rules were motivated by a desire to simplify domestic tax planning and administration. Perhaps inadvertently, they also made the use of hybrid entities for investment into and out of the US much more attractive and certain. For example, a double-dip financing arrangement for the acquisition or expansion of a US business might be structured in the following way.



ACo, a resident of Country A, proposes to acquire all the shares of USCo, a US corporation engaged in an active business in the US. ACo forms a hybrid entity (e.g., an LLC) under the laws of the US or a tax haven in which ACo owns all the units or interests. Under the tax law of Country A, the hybrid entity is treated as a corporation. However, an election is filed under the US check-the-box rules to treat the hybrid entity as a disregarded or transparent entity. ACo also establishes a wholly owned US subsidiary, USHoldco, to acquire the shares of USCo. ACo borrows the purchase price of the USCo shares from a bank in Country A and contributes the borrowed funds to the hybrid entity. The hybrid entity loans the funds to USHoldco, which uses them to acquire the shares of USCo.

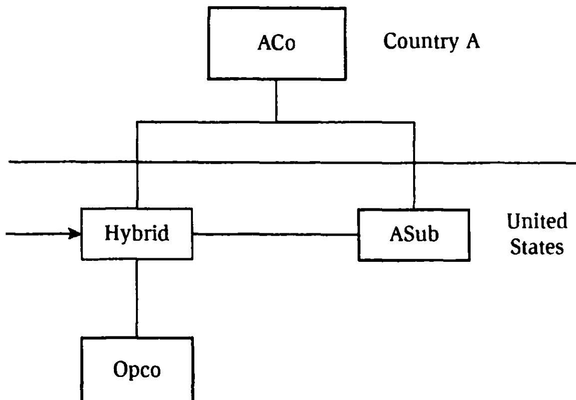
The tax consequences of this type of arrangement are as follows:

- the interest paid by USHoldco is deductible in computing the income of the US consolidated group consisting of USHoldco and USCo;
- the hybrid entity is not subject to US tax on the interest payments received because it is disregarded (i.e., treated as transparent) for US tax purposes;
- the interest payments from US Holdco to the hybrid entity are subject to US withholding tax because they are considered to be paid directly by US Holdco to ACo for US tax purposes;
- the hybrid entity is not subject to Country A tax because it is treated as a nonresident corporation (assuming that the interest is not taxable under Country A's CFC rules); and
- the interest paid by ACo is deductible in computing its income for purposes of Country A tax.

Originally, the rate of US withholding tax on the interest payments was the reduced rate provided in the treaty between the US and Country A, which in some cases was zero. However, in 1997 the US adopted rules to deny the benefit of any reduced rate of withholding under a treaty if the other country did not tax the payment because it treated the hybrid entity as a separate taxable entity. Thus, the structure would no

longer be effective with respect to the US because the interest would be subject to a 30 percent US withholding tax.

For several years, some taxpayers used what were referred to in the US as "reverse hybrid" arrangements to avoid US withholding tax.



On the facts of the previous example, a reverse hybrid would involve ACo forming a hybrid entity under the laws of the US that elects to be treated as a corporation for US tax purposes. The hybrid entity would borrow from a US bank and use the borrowed funds to acquire the shares of USCo, a US-resident corporation engaged in active business. This arrangement is referred to as a reverse hybrid simply because, for US tax purposes, the hybrid entity is treated as a corporation rather than as a partnership or a disregarded entity.

The tax consequences of this reverse hybrid arrangement are as follows:

- the interest paid to the bank is deductible for US tax purposes in computing the income of the hybrid entity and the US consolidated group, consisting of the hybrid entity and USCo;
- no US withholding tax is payable because the interest is paid to a US bank;
- the interest paid to the bank is deductible in computing the income of ACo and ASub for purposes of Country A tax because the hybrid entity is treated as a partnership between ACo and ASub.

In 2001, the US adopted rules for reverse hybrid arrangements, under which a hybrid entity is not entitled to deduct interest payments made to related nonresident persons. Such payments are treated as dividends for US tax purposes and US tax treaties. This dividend treatment applies only to the extent that the hybrid entity receives dividends from related US corporations.

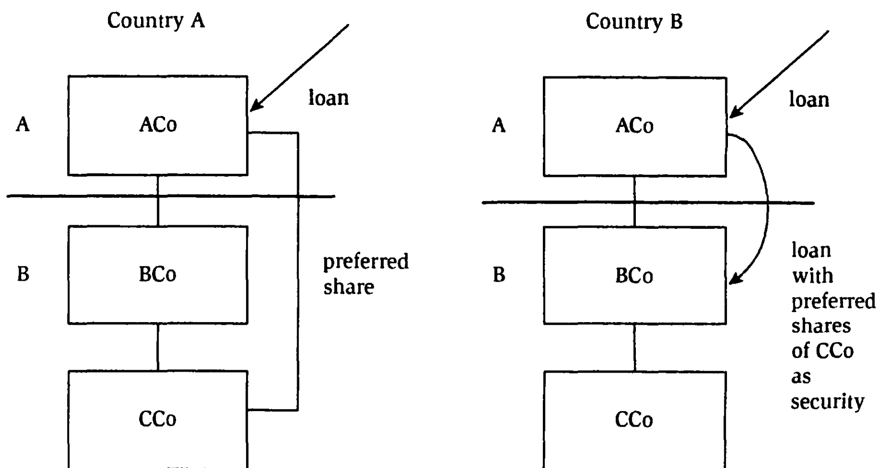
Tax planning with hybrid entities is not for the faint-hearted. It involves the complex interplay of domestic and foreign tax rules, domestic and foreign corporate and commercial law, and tax treaties. The rewards of such planning may be substantial; however, there are also serious risks. For example, in the first hybrid example dealt

with above, if the hybrid entity is considered to be resident in Country A or if the hybrid is considered to be a PE of ACo in the US, the benefits of the arrangement will be nullified. Moreover, any US tax on the payments to the hybrid entity will not be creditable against any Country A tax payable by ACo pursuant to Country A's CFC rules because the US tax is payable by ACo, not by the hybrid entity.

9.3.3 Hybrid Financial Instruments

In general, a hybrid financial instrument is a financial instrument that is characterized differently by two counties. For example, an instrument with characteristics of both debt and equity may be treated as debt by one country but as equity (a share) by another country. Like hybrid entities, these hybrid financial instruments are widely used for tax planning purposes. If a source country treats an instrument issued by a corporation as debt, it will usually characterize the payments on the debt as interest and allow a deduction for those payments. However, the country in which the recipient of the payments is resident may characterize the instrument as a share of the corporate issuer and treat the payments on the share as tax-exempt dividends.

As an example of a hybrid financial instrument that results in a deduction in both the residence and source countries, consider the following sale and repurchase ("repo") arrangement. ACo, a resident of Country A, owns all the shares of BCo, a corporation resident in Country B. In turn, BCo owns all the common and preferred shares of Cco, which is also resident in Country B. ACo borrows money to acquire the preferred shares of CCo from BCo. At the same time, ACo and BCo enter into an agreement under which BCo agrees to repurchase the preferred shares of CCo in five years at a fixed price.



Country A treats these transactions in accordance with their legal form. Thus, ACo is entitled to deduct its interest payments, but, assuming that Country A has a

participation exemption for dividends from foreign corporations, ACo is not taxable on any dividends received on the preferred shares of CCo. In contrast, Country B treats the arrangement in accordance with its economic substance as a five-year loan by ACo to BCo, with the preferred shares of CCo held by ACo as security. Thus, Country B allows BCo to deduct any dividends paid by CCo on the preferred shares as interest. In the result, the arrangement gives rise to interest deductions in both Country A and Country B with no offsetting income inclusion.

9.3.4 OECD BEPS Proposals for Hybrids

The OECD's BEPS Action 2: *Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Law) and (Treaty Issues)*, March 19, 2014, is targeted only at hybrid entities and hybrid financial instruments and transfers rather than all types of hybrid arrangements. More specifically, the OECD proposals are concerned with hybrids that result in a deduction in one country without any income inclusion in the other country, or that result in a deduction in both countries. The OECD proposals are not aimed at timing differences or differences in the value of payments with respect to financial instruments that are attributable to foreign-currency gains and losses.

With respect to hybrid financial instruments, the OECD proposals focus on differences in the characterization of payments (e.g., interest or dividends) on a financial instrument or the underlying property (e.g., debt or shares). For this purpose, a financial instrument is intended to be defined under domestic law, which in some countries may be based on International Financial Reporting Standards (IFRS) or other accounting rules.

With respect to hybrid entities, the OECD proposals target payments made by a hybrid entity where the two countries involved view the payment as being made by different entities, or where one country does not consider a payment to have been made at all. As an example of the second type of hybrid mismatch, consider a situation in which ACo, resident in Country A, loans funds to a wholly owned entity, BCo, resident in Country B. Country B treats BCo as a taxable entity and allows a deduction for the interest paid to ACo on the loan. However, Country A treats BCo as transparent and considers ACo to have a branch or PE in Country B; as a result, Country A does not recognize any payment of interest by BCo to ACo and may exempt ACo's foreign branch profits from Country A tax.

The OECD proposals also target "reverse hybrids," which involve payments received by hybrid entities, and "imported mismatches," which are hybrid arrangements created under the laws of two countries and imported into a third country. As an example of an imported hybrid mismatch arrangement, consider the following example. BCo, resident in Country B, issues a hybrid financial instrument to its parent, ACo, resident in Country A. The payments by BCo to ACo are deductible by BCo in Country B but are not taxable by Country A to ACo. BCo then loans funds to an unrelated company, CCo, in Country C. The interest payments on the loan are deductible by CCo in Country C and are included in BCo's income, offsetting the

deductible payments by BCo to ACo. In effect, the benefits of the hybrid arrangement between Country A and Country B are shifted to a third country, Country C.

To counter the beneficial tax results of the different types of hybrid arrangements described above, the OECD recommends a series of specific rules rather than a comprehensive general response. The rules are very complex and will be difficult for the tax authorities of many countries, especially developing countries, to apply.

The OECD recommendations consist of domestic rules to be adopted by countries unilaterally and domestic rules that, although adopted unilaterally, are intended to be coordinated with the rules of other countries. For this purpose, one country is considered to be the primary country to take action against the targeted hybrid arrangement, and the other country is considered to be the secondary country whose anti-hybrid rules should apply only if the primary country does not deal with the hybrid arrangement.

In the case of hybrid arrangements involving deductions in one country but no income inclusion in another country, the country in which the payer is resident is the primary country. However, with respect to hybrid financial instruments, the OECD recommends that the country in which the recipient is resident (the secondary country) should deny any deduction or exemption for payments that are deductible by the payer. In either case, in order to apply the hybrid arrangement rules properly, it will be necessary for countries to obtain detailed information about the treatment of payments on hybrid financial instruments in another country. This is not typically something about which the tax authorities of most countries have much experience.

In the case of hybrid entity payments involving double deductions, the primary country is the country in which the recipient of the payment is resident, and it is expected to deny a deduction for the payments. A similar approach applies to hybrid entity payments involving a deduction in one country but no income inclusion in the other country, reverse hybrids, and imported mismatches. In these situations, the primary country is the country in which the recipient of the payment is resident. Thus, the country in which the payer is resident is expected to deny a deduction for the payment, or require the payment to be included in income if the other country allows a deduction. If, however, the primary country does not do so, the secondary country is expected to deny any deduction for the payment.

9.4 FEES FOR MANAGEMENT, TECHNICAL, AND CONSULTING SERVICES

9.4.1 Introduction

As discussed in Chapters 2 and 5, most countries tax nonresidents on their domestic source income. Some countries tax nonresidents on all their domestic source income; other countries tax nonresidents on their domestic source business income only if a minimum threshold, such as a PE or a minimum period of physical presence, is met. Under the provisions of the OECD and UN Model Treaties, a source country is generally entitled to tax the profits of a business carried on by a resident of the residence country

only if the business is carried on through a PE located in the source country, and only to the extent that the profits are attributable to the PE.

As a result of these provisions of domestic law and tax treaties, taxpayers, especially multinational enterprises, can structure their business operations to erode the tax bases of source countries through payments for technical, management, and consulting services, as shown in the following example. ACo, a corporation resident in Country A, is the parent corporation of a multinational group of companies involved in the hotel business. The group has a hotel in Country B that is owned by BCo, a wholly owned subsidiary of ACo, which is resident in Country B, a high-tax country; BCo is taxable by Country B on its profits from the operation of the hotel. In computing its profits, BCo is entitled to deduct expenses incurred to earn its income. The expenses incurred by BCo include management fees and consulting fees paid to CCo, another wholly owned subsidiary of ACo, that is resident in Country C, a low-tax country.

This structure may result in substantial tax savings for the multinational enterprise, essentially because the management and consulting fees are deductible against Country B's tax base and are taxable at a low rate in Country C. The deductions for the fees claimed by BCo are, of course, subject to Country B's transfer pricing rules since the fees are paid to a related party. However, the tax savings are not dependent on the payment of amounts that are more or less than the arm's-length amount; they are available even if the fees are what arm's-length parties would have paid. Also, CCo would not be taxable by Country B on the fees because Country C does not impose tax on CCo's fees under its domestic law, or because, under the tax treaty between Country B and Country C, Country B is entitled to tax business profits derived by a resident of Country C only if the resident carries on business through a PE in Country B. CCo will be careful to avoid creating a PE in Country B.

Some developing countries have special rules in their domestic law for taxing nonresidents on fees for management, technical, and consulting services derived by nonresidents. Under these rules, withholding tax is imposed on the gross amount of payments by residents to nonresidents for management, technical, and consulting services whether or not the services are performed in the country. If the nonresident service provider performs services in the source country, the income is clearly derived from the source country, in accordance with the conventional notion that the source of income from services is where the services are performed. If, however, the services are provided outside the source country, it is quite controversial to consider the income from the services to be derived in the country in which the services are used or consumed.

One basic difficulty with these rules is that the types of services to which the rules apply are often not defined precisely. Some countries distinguish between technical assistance, which generally involves a transfer of know-how or technical expertise (analogous to the transfer of the right to use intellectual property), and technical services, which involve the application of specialized knowledge or skill. The definition of technical services is similarly problematic under the provisions of tax treaties, as discussed below.

Even if the provisions of a developing country's domestic law impose tax on income from technical services earned by a nonresident, the provisions of an applicable tax treaty may limit that tax, as discussed in the next section.

9.4.2 The Taxation of Income from Management, Technical, and Consulting Services under Tax Treaties

This section provides a brief review of the provisions of the OECD and UN Model Treaties that are potentially applicable to income from management, technical, and consulting services (referred to here for convenience simply as "technical services") and an overview of the provisions dealing with income from such services that some developing countries have included in their tax treaties.

Neither the OECD nor the UN Model Treaty currently contains any specific provisions dealing with income from technical services provided by a resident of one state in the other contracting state or to customers in the other contracting state. In general, income from business services is covered by Article 7 of the OECD Model Treaty or Article 7 or 14 of the UN Model Treaty. Under Article 7(1) of both Model Treaties, a country is entitled to tax a nonresident's business profits only if the nonresident carries on business in the country through a PE. A PE is defined in Article 5 to be a fixed place of business that must generally last for a minimum period of six months. Under Article 5(3)(b) of the UN Model Treaty, a nonresident is deemed to have a PE in the source country if the nonresident furnishes services in the source country for more than 183 days in any twelve-month period in respect of the same or a connected project. The fixed-place-of-business rule can be easily avoided by some nonresident service providers by limiting the time spent in the source country, by not working at any one place for more than six months, by splitting large contracts into several smaller ones, or by having projects carried out by related parties.

Under Article 14 of the UN Model Treaty (Article 14 was deleted from the OECD Model Treaty in 2000), income derived by a nonresident individual from professional or other independent services performed in the source country is taxable by the other state only if the income is attributable to a fixed base in that country that is regularly available to the nonresident, or if the nonresident is present in the source country for 183 days or more in any twelve-month period. It is generally accepted that the source country must tax income under Article 7 or 14 on a net basis. The distinction between technical services and professional and business services that involve technical expertise is unclear. For example, engineering services would often be considered to be technical services; however, the independent activities of engineers are included in the definition of "professional services" for purposes of Article 14 of the UN Model Treaty. Thus, income from engineering services, or at least those performed by individuals, would be taxable by a source country only if the engineer has a fixed base in that country or stays in that country for 183 days or more in any twelve-month period.

Article 12 of both the OECD and UN Model Treaties dealing with royalties does not apply to fees for management, technical, or consulting services because the

definition of royalties in Article 12(3) is limited to payments for the use of, or the right to use, intellectual property, equipment, or information.

The erosion of the source country's tax base by payments for technical services, and the inability of the source country to tax such payments, has led some countries to add specific provisions to their tax treaties to allow them to tax payments for technical services on a gross basis. A 2011 survey by the International Bureau for Fiscal Documentation (IBFD) found that 134 of the 1,600 tax treaties concluded between 1997 and 2011 contained a separate article dealing with fees for management, technical, and consulting services. Under these special articles, income from technical services are, in effect, treated like royalties. Some countries, such as India, extend Article 12 dealing with royalties to include payments for services that are ancillary or subsidiary to the application of intellectual property, or that make available technical knowledge, skill, know-how or processes, or that involve the development of a technical plan or design. The Indian approach is unsatisfactory because it muddles the distinction between royalties for the transfer of the right to use intellectual property and fees for services, which do not involve any transfer of know-how or property by a service provider to a client.

Typically, the special articles in tax treaties dealing with fees for technical services limit source country tax to fees for such services "arising" in the source country, which usually means that the services must be performed in the source country. Moreover, the expression typically used in these provisions - "managerial, technical or consultancy services" - is not usually defined.

9.4.3 Proposed Article on Fees for Management, Technical, and Consulting Services in the UN Model Treaty

The UN Committee of Experts has been working on the taxation of income from services for several years, and in 2013 the Committee decided in principle to add a new article to the UN Model Treaty dealing with fees for management, technical, and consulting services. The new article and Commentary are likely to be added to the UN Model Treaty at the time of its next update, which is scheduled for 2016 or 2017. Under the new article, fees for management, technical, and consulting services will be taxable by a contracting state on a gross basis by way of withholding if the fees arise in that state. Fees for management, technical, and consulting services will be considered to arise in a contracting state if the payer is a resident of that state, or is a nonresident with a PE in that state and the fees are deductible in computing the profits attributable to the PE.

In effect, under the new article, fees for management, technical and consulting services will be taxable by a state on a gross basis irrespective of where the services are provided and without any threshold such as a PE or fixed base. This contrasts sharply with the treatment of such fees under the existing provisions of both the OECD and the UN Model Treaties (taxation on a net basis only if the services are performed in the source country through a PE or fixed base). Not surprisingly, the new article is controversial and has been vigorously opposed by several developed countries. It

remains to be seen whether developing countries will be successful in negotiating the inclusion of the new article in their tax treaties, especially treaties with developed countries.

9.5 ARBITRATION

As discussed in Chapter 8, section 8.8.3, tax treaties typically contain an article providing for a mutual agreement procedure (MAP) to resolve disputes between the contracting states with respect to the application and interpretation of the treaty. Under Article 25(2) of the OECD and UN Model Treaties, the competent authorities of the two states are required to endeavor to resolve disputes submitted by a taxpayer; however, they are not obliged to do so. Therefore, in some cases, the competent authorities may not be able to reach an agreement, with the result that a taxpayer may be subject to unrelieved double taxation. Moreover, there are no time limits for the resolution of disputes by the competent authorities, and mutual agreement cases have been known to drag on for many years.

Disputes between taxpayers and tax authorities concerning relief from double taxation and other issues have arisen more frequently as international trade and investment have become more sophisticated, tax treaties have proliferated, and countries have become more aggressive in enforcing their transfer pricing rules. Consequently, the need for a more efficient and certain process for resolving tax disputes became obvious. Pressure from multinationals and a few influential developed countries led the OECD to include a compulsory arbitration provision in Article 25(5) of the OECD Model Treaty in 2008; Article 25 of the UN Model was amended in 2011 to add an optional arbitration provision. Because arbitration has been added to the OECD and UN Models so recently, it has been included in only a few bilateral tax treaties to date, and those treaties are invariably between developed OECD member countries. As a result, information about the actual experience of countries with arbitration is scarce, and at best anecdotal.

Arbitration forms part of the MAP provided in Article 25 of both Model Treaties. Arbitration is not available independently of a MAP, and is not available if the competent authorities of the contracting states agree that taxation has been imposed in accordance with the treaty; it is available only where the competent authorities have not been able to reach an agreement on one or more issues. Arbitration is not available for an entire MAP case, since the resolution of a case as a whole is the function of the MAP. In effect, arbitration is used to resolve certain issues within the MAP on which the competent authorities are unable to agree. Because arbitration is a part of a MAP, it is subject to any and all of the limitations on the MAP.

Article 25(5) of the OECD Model Treaty provides that a taxpayer can request that any unresolved issues in a case submitted for a MAP under Article 25(1) be resolved by arbitration if the competent authorities have not been able to resolve the case within two years. However, arbitration is not available if the unresolved issues have already been decided by a domestic court or administrative tribunal. The decision of the arbitrators is binding on the competent authorities (unless it is rejected by the

taxpayer), and must be implemented irrespective of any time limits in domestic law. The competent authorities are authorized to settle the details of the arbitration process by way of a mutual agreement. A sample mutual agreement on arbitration is included in an annex to the OECD Commentary on Article 25.

Article 25 of the UN Model Treaty contains two alternative versions of the MAP, only one of which provides for arbitration. Under paragraph 5 of Article 25 (alternative B), unresolved issues in a MAP case under Article 25(1) that have not been resolved within three years can be submitted for arbitration at the request of one of the competent authorities. The taxpayer is entitled to be notified of the request.

The major differences between arbitration under the UN and OECD Model Treaties are as follows:

- arbitration is an alternative under the UN Model Treaty;
- arbitration under the UN Model Treaty is available at the request of the competent authorities rather than at the request of the taxpayer, as is the case under the OECD Model Treaty;
- issues can be submitted for arbitration under the UN Model Treaty only if they have not been resolved by the competent authorities within three years, rather than the two-year period under the OECD Model Treaty; and
- under the UN Model Treaty, the competent authorities have six months after the arbitration decision has been made to reach a different resolution of the issues.

Apart from these differences, the arbitration process under the UN Model Treaty is the same as under the OECD Model Treaty, as described above. However, the Commentary on the UN Model Treaty also provides for an alternative voluntary arbitration process, under which both competent authorities must agree to submit cases to arbitration on a case-by-case basis.

According to the OECD, the purpose of arbitration is to enhance the effectiveness of the MAP by providing a dispute-resolution mechanism for issues about which the competent authorities cannot agree. However, from a taxpayer's perspective, arbitration has the effect of and, arguably at least, the purpose of, forcing the resolution of issues submitted to arbitration in a manner that is binding on the competent authorities. Typically, in a MAP without binding arbitration where the competent authorities cannot agree, the result is unrelieved double taxation. Therefore, forcing the competent authorities to agree through arbitration provides taxpayers with certainty and will often eliminate double taxation, to the benefit of taxpayers.

To the extent that issues are submitted to arbitration, the competent authorities give up control over the resolution of these issues to independent arbitrators, who may not fully appreciate the significance of the issue for a country's tax system. Rather than have the issue decided through arbitration, the competent authorities are effectively nudged toward resolving the issue themselves. Thus, arbitration imposes discipline on the competent authorities to resolve cases subject to a MAP that would otherwise be lacking.

Under both the OECD and UN Model Treaties, arbitration is available only if a person has presented a case for a MAP under Article 25(1) to the competent authority of the state of which the person is resident. The case must involve actions by one or both of the contracting states that have resulted (or will result) in taxation contrary to the provisions of the treaty, and it must be presented to the competent authority within two or three years of the first notification to the person of the actions. MAP cases under Article 25(3) that involve the interpretation or application of the treaty or the elimination of double taxation not provided for in the treaty do not qualify for arbitration, although contracting states have the option of extending arbitration to those issues.

Although arbitration under the OECD Model Treaty is initiated by a taxpayer, once it begins, it is a state-to-state process controlled by the competent authorities. In contrast, under the UN Model Treaty, arbitration is initiated at the request of one of the competent authorities. Although the initiation of arbitration by one of the competent authorities seems to be significantly different from taxpayer-initiated arbitration, the competent authority requesting arbitration would likely have consulted with the taxpayer involved beforehand, and in most cases would accede to the taxpayer's wishes concerning recourse to arbitration.

Under the arbitration provisions in both the OECD and UN Model Treaties, arbitration is not available for issues where a domestic court or administrative tribunal of either contracting state has already rendered a decision on those issues. In most countries, the competent authorities would not be able to implement an arbitration decision that is contrary to a domestic decision. This limitation is consistent with the similar limitation on the MAP generally.

Arbitration is available only for cases presented by a person for a MAP under Article 25(1) where the actions of one or both of the contracting states have "resulted for the person in taxation not in accordance with the provisions of this Convention." Therefore, for example, issues involving exchange of information and assistance in collection would not qualify for arbitration because they do not involve taxation contrary to the treaty. Most issues submitted for arbitration are likely to involve the distributive provisions of a treaty (Article 6 through 21), especially Article 9 dealing with transfer pricing disputes. Some countries limit arbitration to specified provisions of the treaty, such as Article 4 (residence), Article 5 (PEs), Article 7 (attribution of profits to PEs), Article 9 (transfer pricing), and Article 12 (royalties); others limit arbitration to questions of fact. Under several US tax treaties, arbitration may be rejected for an issue if both competent authorities agree; however, there are no standards or criteria for the denial of access to arbitration.

Like the MAP generally, arbitration is not intended to displace domestic law remedies or to force a taxpayer to choose between the two dispute resolution mechanisms. To avoid duplication, domestic remedies are usually suspended until the arbitration is complete. Once the arbitration and MAP are completed, the taxpayer has the choice of accepting the decision of the competent authorities or rejecting it and pursuing domestic remedies. If a taxpayer rejects the result of a MAP involving arbitration, the process might be viewed as a waste of time and resources. Since arbitration is invoked at the option of the taxpayer, arguably the taxpayer should be

bound by the decision of the arbitrators. However, it would be unfair (and possibly a violation of human rights) to deprive taxpayers of their access to domestic courts, although, according to the OECD, it is rare for taxpayers to reject a mutual agreement in order to have recourse to domestic courts. Alternatively, the taxpayer may be required to waive access to domestic remedies as a condition for arbitration; the competent authorities will usually require the taxpayer to do so as a condition for the implementation of a MAP involving arbitration.

Until countries develop sufficient experience with arbitration, especially mandatory arbitration, to feel comfortable with its operation as a mechanism for resolving disputes, they are unlikely to expand the availability of arbitration beyond what is currently provided in the OECD and UN Model Treaties. In fact, it might be expected that countries will limit the types of issues qualifying for arbitration even more narrowly.

The detailed procedures for arbitration under a tax treaty are usually set out in a memorandum of understanding between the competent authorities. In general, there are two basic types of arbitration. One type is a quasi-judicial process in which the arbitration panel receives submissions, hears arguments, and provides a written decision with reasons, which is not limited to the positions put forward by the competent authorities. Decisions may or may not be published publicly, depending on whether the competent authorities want to establish a body of decisions that might have precedential value. Under so-called "baseball" or last-best-offer arbitration, the arbitration panel is limited to choosing between the positions taken by the competent authorities and is not required or allowed to provide written reasons for its decision. Baseball arbitration is used by countries that are concerned about compromising their sovereignty and want to limit arbitration as much as possible. It is thought to be less expensive, faster, and more effective in forcing the competent authorities to adopt reasonable positions and resolve cases without the need for arbitration.

Typically, an arbitration procedure involves the appointment of a panel consisting of three arbitrators, one appointed by each competent authority, and the chair, chosen by the other two arbitrators, often from a list preapproved by the competent authorities. The arbitrators are often former judges, government officials, or internationally recognized tax experts. The panel receives written (and sometimes oral) submissions from the competent authorities, and possibly from the taxpayer, depending on the procedures agreed to by the competent authorities.

The OECD BEPS Action 14: *Make Dispute Resolution Mechanisms More Effective*, December 18, 2014, acknowledges the absence of a clear obligation on the competent authorities to resolve MAP cases and the lack of consensus on mandatory arbitration. Therefore, Action 14 recommends that complementary steps be taken to improve access to the MAP and to make the MAP more efficient and effective in order to ensure that disputes are resolved once a MAP has been initiated. In general, Action 14 recommends that minimum standards for MAP cases should be established, and also that a monitoring process should be established to ensure that participating countries adhere to the minimum standard. With respect to arbitration, the OECD suggests that the Commentary on the OECD Model Treaty could be revised to allow countries to narrow the scope of issues subject to arbitration, clarify the relationship between

arbitration decisions and domestic law remedies, and promote the use of most-favored-nation provisions to facilitate the adoption of arbitration.

9.6 THE DIGITAL ECONOMY - ELECTRONIC COMMERCE

9.6.1 Introduction

One of the major technological innovations of the late twentieth century was the development and widespread use of the Internet for conducting and facilitating various personal and business activities. The Internet was initially developed by some US research universities operating under grants from the US government. It was designed to facilitate communication among researchers and to serve as a secure communication system in the event of a major war. As the Internet expanded in scope and reach, its commercial implications were discovered and exploited by a tremendous variety of large and small vendors, leading to further expansion and development. Commerce has clearly driven the development of the Internet.

In the second edition of this Primer, the discussion in this section focused on commercial activities conducted over the Internet ("electronic commerce") such as online sales and services. The term "electronic commerce" suggests that such commerce can be distinguished from other, more traditional forms of commerce. In the last decade, however, digital activities have permeated so many aspects of commercial life that it is now customary to refer to the digital economy.

The digital economy is the product of information and communication technologies featuring global connectivity on a 24/7 basis through a variety of mobile devices such as tablets, smart phones, and wearable devices. Key features of the digital economy include the conversion of tangible goods into digital products, global connectivity through mobile devices, and the gathering, analysis, and commercialization of data collected from customers. A common example of the conversion of tangible goods into digital products is the increasing replacement of traditional books, magazines, and newspapers by e-publications. The growth in 3D printing has the potential to turn traditional manufactured goods into intangibles that are licensed to customers who perform the manufacturing themselves. The connectivity of the digital economy means that businesses can access customers wherever they are and at all times (as long as they have a mobile device and access to the Internet) and that businesses can locate their personnel and information technology wherever they want. For this reason, the digital economy is often said to be borderless. Consumers play a more active role in the digital economy in a variety of ways: creating content (e.g., YouTube), using multi-sided platforms (e.g., Google, eBay, and Amazon) and providing a source of big data.

Examples of the digital economy include:

- the collection of personal data by businesses from customers that is used to tailor marketing activities to them on a personalized basis;
- the use of logistics to track the movement of vehicles and cargo globally;
- 3D printing and cloud computing;

- the use of social networks for accessing news and entertainment;
- the delivery of online educational materials and training;
- the diagnosis and treatment of health care patients from remote locations;
- virtual currencies such as Bitcoin; and
- the sharing economy, such as the taxi service Uber and the accommodation sharing service Airbnb.

The digital economy has resulted in the development of several new models for doing business in addition to electronic commerce. Different types of payment services and new forms of online advertising have been developed. Many types of business activities take place on networked platforms; online app stores have flourished with the development of digital goods and services; cloud computing has arisen to provide a variety of services (infrastructure-as-a-service, platform-as-a-service, software-as-a-service, content-as-a-service, and data-as-a-service) through a network of computers storing software, data and other resources that are available to customers for a fee. The sources of revenue from these new business models include sales of digital goods and services, advertising, subscriptions, sales of data, and fees for transactions.

9.6.2 Tax Challenges Posed by the Digital Economy

In general, the digital economy presents three major challenges for the current international tax system. First, as noted above, the digital economy is borderless; it permits businesses to be conducted globally and remotely. In the digital economy, businesses can engage with customers in a country without the need for any physical presence - assets or personnel - in that country. Second, the digital economy presents many difficult issues of characterization with respect to new sources of revenue. Third, although data have become an important source of value in the digital economy, it is difficult for tax systems to capture the income from such data. Each of these issues is discussed further below.

The tax issues raised by the digital economy are not new. For example, for many years mail-order businesses have been able to sell to customers in countries without any physical presence there. It is the scale of the digital economy that threatens existing sources of tax revenue.

In general, nonresidents are taxable on income derived from the digital economy under the same domestic tax rules applicable to income derived from other types of activities. As discussed in Chapter 5, many countries tax nonresidents on business profits only if the nonresidents meet some minimum threshold based on physical presence in a country. Similarly, under most tax treaties, a resident of one contracting state is not taxable on business profits derived from the other contracting state unless the resident has a PE in the other state and the profits are attributable to the PE. A PE is defined to be a fixed place of business or a dependent agent with authority to conclude contracts, and does not include a place or an agent that is used to carry out only preparatory or auxiliary activities.

Therefore, often the first issue for countries that wish to tax income from the digital economy is whether the nonresident enterprise deriving the income meets the minimum domestic threshold for source country taxation and, if it does, whether it has a PE in the source country for the purposes of an applicable tax treaty. The Commentary on Article 5 of both the OECD and UN Model Treaties indicates that the following activities will not generally give rise to a PE:

- *The sale of goods and services and other activities in a country through a website on a computer located in that country.* According to the OECD and UN Commentary on Article 5, a PE requires an enterprise to have some physical presence (although not necessarily a human presence) in a country, and a website is intangible. Although a few countries (Chile, Greece, India, and Portugal) have indicated that they disagree with the position taken in the Commentaries, that position seems to represent an international consensus. Although an argument can be made that a website that performs the same functions as a bricks-and-mortar store should be treated as PE, there would be insurmountable problems in applying and enforcing such a rule.
- *The use of computer equipment, such as a server, in a country to store or provide access to electronic files or otherwise to assist a taxpayer in conducting its business operations.* The Commentary recognizes that the place where computer equipment is kept could be considered to be a PE if the place meets the requirements of Article 5. In most cases, however, such a place will not meet these requirements because the place is not at the disposal of the nonresident enterprise or the activities carried on by the server are preparatory or auxiliary. In any event, any country that takes the position that a computer server constitutes a PE would likely find that any servers in the country would be moved to more hospitable jurisdictions.
- *The use in a country of an agent, such as an internet service provider (ISP), to provide access to the Internet or to host a web site.* Under Article 5 of both Model Treaties, an independent agent acting in the ordinary course of its business does not create a PE for its principal. In most cases, therefore, an ISP would be considered to be an independent agent because it is merely providing Internet access to the public and is roughly comparable to a telephone company providing telephone service to its customers. This position, which is reflected in the Commentary on Article 5 of both the OECD and UN Model Treaties, does not appear to be controversial.

The characterization of income derived from digital transactions is important in applying the provisions of a tax treaty. For example, income characterized as business profits is taxable by a source country in accordance with Article 7 of the OECD and UN Model Treaties only if the enterprise has a PE in that country and the income is attributable to the PE. Business profits are taxable on a net basis after the deduction of the costs of earning the income. As discussed above, the OECD and UN Commentaries suggest that a PE does not include a website that functions as a virtual office. As a

result, most income from digital activities characterized as business profits would not be taxable in the source country.

Income characterized as royalties is taxable under Article 12 of the OECD and UN Model Treaties. Article 12 of the OECD Model Treaty provides that royalty income is exempt from tax in the source country. In contrast, the UN Model Treaty allows a source country to tax royalties at a rate to be agreed on by the contracting states.

In many cases, income from digital transactions is easy to characterize. For example, income derived from sales over the Internet of tangible goods would be business income, and income from providing access over the Internet to a database containing proprietary information would be royalties. Some types of income from the digital economy, however, present problems of characterization. The Commentary on Article 12 of both the OECD and UN Model Treaties takes the position that the consideration for the acquisition of computer software over the Internet may be treated as royalties or as business profits, depending on the facts. If the transferee acquires rights to use the software in a way that would constitute an infringement of copyright in the absence of a license to use the software, the consideration should be treated as a royalty. However, if the transferee acquires only limited rights necessary to operate the program, (e.g., to copy a program onto the user's computer), the consideration should be treated as business profits, despite the legal form of the transaction as a license. However, some countries take the position that payments for software are royalties. The OECD and UN Commentaries also extend the principles applicable to the treatment of computer software to other digital products.

In summary, the tax challenges posed by the digital economy are like the weather: everybody likes to talk about it, but nobody does anything about it. The OECD BEPS Action 1: *Addressing the Tax Challenges of the Digital Economy,* is no exception. The OECD Report presents an excellent description of the digital economy and the risks it poses for the international tax system. However, concrete recommendations for coordinated action to deal with digital transactions are absent from the Report. The reason is that any meaningful response to the challenges posed by the digital economy requires fundamental changes to the rules of the international tax system that allocate tax revenues between source and residence countries. Although the Report raises the possibility of adopting a significant-presence threshold (rather than the existing PE threshold) for cross-border sales of digital goods and services and a withholding tax on payments for digital goods and services, it does not suggest that these options will be pursued except as aspects of ongoing work on the digital economy. Instead, the Report expresses the view (the hope?) that other aspects of the BEPS project, such as the work on Action 7: *Preventing the Artificial Avoidance of PE Status,* may limit the base-eroding effects of the digital economy.

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[illegible]

[illegible] production.

In summary, [illegible]

[illegible]

Glossary of International Tax Terms

183-day rule A rule used by many countries under which an individual is deemed to be a resident if the individual is present in the country for 183 days or more in the aggregate in any twelve-month period.

Advance pricing agreement (APA) An agreement between a multinational enterprise and the tax authorities of one or more countries approving the transfer pricing method to be used by the enterprise in future tax years.

Arm's-length method, (standard, principle, or approach) The establishment of transfer prices in transactions between related parties based on the prices charged (or sometimes the profits derived) in similar transactions between unrelated parties.

Arm's-length price A price set on a transfer of goods, services, or intangible property between related persons that corresponds to the price that would be set in a similar transfer between unrelated persons.

Back-to-back arrangements An arrangement involving a transaction, such as a loan or lease, by a person to an intermediary, followed by a similar transaction by the intermediary to another person who may be related to the first person. A back-to-back arrangement is almost always used as a tax avoidance device.

Base company income Business income derived by a controlled foreign corporation from the country in which its controlling shareholders are resident or from transactions with related parties that occur outside the country in which the foreign corporation is established.

Base erosion and profit shifting (BEPS) A project launched by the G20/OECD in 2012 to deal with aggressive tax planning by multinational enterprises that result in the reduction of the tax bases of high-tax countries.

Beneficiary or beneficiaries of a trust The persons, individuals, or legal entities who beneficially own property held in trust for them by a trustee or trustees, who have legal title to the property.

Branch A business carried on by a taxpayer, usually through an office or other fixed place of business. A branch is not separately incorporated. A foreign branch is a branch located outside the taxpayer's country of residence.

Branch tax A tax imposed by a country on the profits of a branch of a nonresident enterprise that are not reinvested in the country; the tax is intended to perform the same function as a withholding tax on dividends paid by a resident subsidiary to its foreign parent corporation.

Capital-export neutrality The situation that exists where resident investors bear the same tax burden whether they invest at home or abroad.

Capital-import neutrality The situation that exists where residents investing in a source country bear the same tax burden as other investors in that country.

Capital-ownership neutrality The situation that exists where the owners of investments bear the same tax burden irrespective of their countries of residence.

Check-the-box rules US tax rules that, under most circumstances, allow taxpayers to choose to have an entity (other than certain per se corporations) treated as a corporation, partnership, branch, or disregarded entity for tax purposes.

Commentary The Commentary on the OECD Model Treaty or on the UN Model Treaty, which explains how the provisions of the Model Treaty should be interpreted and applied.

Commissionaire arrangements A legal relationship recognized under the law of civil law countries under which one person, the commissionaire, enters into contracts for the sale of goods owned by another person that are legally binding on the commissionaire, but not on that other person.

Comparable profit method (CPM) A transfer pricing method used by the United States that is based on a comparison of the profits earned from similar businesses. CPM is similar to the transactional net margin method (TNMM) authorized by the OECD Transfer Pricing Guidelines.

Competent authority An official of a treaty country who is responsible for the resolution of disputes and issues of interpretation arising under a tax treaty.

Consolidation (consolidated) Rules that permit related corporations - typically a parent corporation and its subsidiaries - to aggregate their income and losses, thereby allowing the losses of one affiliated corporation to offset the profits of another corporation.

Contracting states The countries that are parties to a tax treaty.

Controlled foreign corporation (CFC) rules Rules that require the passive income and certain other tainted income of foreign corporations controlled by resident shareholders to be included in the income of those shareholders, whether or not such income is distributed.

Corresponding adjustment A modification by one country to a transfer price used by a taxpayer to take account of a modification made by another country to the transfer price used by a related taxpayer.

Cost-contribution arrangements A contractual arrangement under which the prospective users of intangible property jointly develop and share in the costs of developing that property and in ownership rights to that property. Such arrangements are called "cost-sharing arrangements" in the United States.

Credit method Foreign taxes paid by a resident of a country are credited against the residence country's tax on the resident's foreign source income.

Cross-border transactions Transactions that have potential tax consequences in more than one country.

Deduction method Foreign taxes paid by a resident of a country are deductible in computing the resident's taxable income in the residence country.

Deferral The practice of subjecting to taxation the profits derived from foreign investment through foreign corporations only when the profits are repatriated to the country of residence of the investor.

Designated jurisdiction approach Under this approach, a country identifies certain countries as low-tax countries for purposes of applying its CFC rules to CFCs resident in those countries.

Direct investment An equity investment in a company that is likely to provide the investor with substantial influence in the management of the company. An ownership interest of over 50 percent of the outstanding shares of a company is always classified as a direct investment. Many countries treat an ownership interest of 10 percent or more as a direct investment.

Double-dip lease A leasing arrangement under which the lessor and the lessee are both able to claim the tax benefits of ownership of the leased property in their country of residence because the countries characterize the transaction differently.

Dual-resident taxpayer A taxpayer who is a tax resident of two or more countries for the same tax year.

Earnings-stripping rules Rules under which the interest deductions claimed by resident enterprises are limited by reference to a percentage of some measure of their income, such as EBITDA.

Entity approach An approach for applying CFC rules under which either all, or none, of a CFC's income is taxable to its resident shareholders

Exemption method Exemption from domestic tax of some or all foreign source income derived by residents.

Exemption with progression A method for relieving double taxation under which foreign source income is exempt from tax but is taken into account in determining the rate of tax applicable to other income.

Exit or departure tax A tax imposed by a country on the accrued income and capital gains of a person giving up residence in that country.

Force-of-attraction principle The taxation by a country of a nonresident with a PE in that country on all the income derived in that country by the nonresident, and not just the income attributable to the PE.

Foreign affiliate A foreign corporation in which a domestic taxpayer has a significant direct or indirect ownership interest (usually 10 percent or more of the shares).

Foreign investment fund rules Rules designed to tax residents on their interest in an offshore or foreign investment fund.

Foreign tax credit A provision that permits domestic tax otherwise payable to be reduced by foreign tax paid on foreign source income.

Formulary apportionment A method for allocating the profits or losses of a multinational enterprise among the countries in which it operates in accordance with a formula based on factors such as sales, assets, and payroll.

Global approach An approach for applying CFC rules under which the CFC rules apply to CFCs irrespective of the country in which they are resident.

Gross-up A notional amount added to the amount of a dividend received by a shareholder, usually equal to the portion of the tax paid by the corporation that is attributable to the dividend, with the result that the dividend plus the gross-up amount equals the before-tax income of the corporation out of which the dividend was paid.

Hybrid entity An entity that is treated as a separate taxable entity (usually as a corporation) in one country and as a transparent or flow-through entity (often as a partnership) in another country.

Hybrid financial instrument A financial product or instrument that is characterized in one way (e.g., debt) for purposes of one country's tax system but in another way (e.g., equity or shares) for purposes of another country's tax system.

Indirect foreign tax credit A foreign tax credit allowed to a domestic taxpayer when it receives a dividend from a foreign corporation for the underlying foreign corporate taxes paid by the foreign corporation on the income out of which the dividend is paid.

Inter-nation equity A concept requiring a fair sharing of the tax revenue derived from taxation of transnational income between capital-importing and capital-exporting countries.

International double taxation The imposition of income tax by two or more countries on the same income of the same taxpayer for the same taxable period.

Inward-bound (in-bound) transaction A transaction in which a nonresident of a country invests capital or other resources in the country.

Limited liability company (LLC) An entity that is treated as transparent under the tax laws of a country but which provides the investors in the entity with limited liability under the general laws of that country.

Limitation-on-benefits article A provision included in tax treaties that is intended to prevent the benefits of the treaty from being granted to residents of third states and to limit the benefit of the treaty to persons who are genuine residents of one of the contracting states.

Most-favored-nation treatment The treatment by one country of the residents or citizens of another country not less favorably than the treatment of the residents or citizens of any other country (but not its own residents or citizens).

Mutual agreement procedure A process provided under tax treaties for the resolution of disputes concerning the interpretation and application of the treaty by the competent authorities of the contracting states.

National treatment The treatment of nonresidents or foreigners by a country not less favorably than the treatment of its own residents or citizens.

Neutrality A tax is neutral if its imposition does not alter the economic decisions that would be taken in its absence.

Nondiscrimination A generally accepted notion that a country should tax nonresidents, foreigners, and foreign-owned domestic corporations in a manner that is the same as or functionally equivalent to the treatment of residents, citizens, or domestically owned corporations in similar circumstances.

Nonresident A person who does not have sufficient connections with a country to be liable to tax there on worldwide income and who is taxable only on income from sources in that country.

Organisation for Economic Co-operation and Development (OECD) An organization of the major developed countries of the world, with its headquarters in Paris.

OECD Model Treaty A model income tax treaty sponsored by the OECD on which virtually all bilateral income tax treaties are patterned.

Foreign investment fund A unit trust or mutual fund established in a foreign country, often a tax haven, to make passive investments in stocks, bonds, and other investment assets. The investors are generally residents of high-tax countries, and the fund usually accumulates its income.

Outward-bound (out-bound) transaction A transaction in which a resident of a country invests capital or other resources outside the country.

Parent corporation A corporation that controls another corporation (referred to as a subsidiary).

Participation exemption A tax regime under which dividends received from foreign corporations by a resident corporation are exempt from residence country tax if the resident corporation owns at least some minimum percentage of the shares of the foreign corporation.

Permanent establishment (PE) A concept used to determine if an enterprise has sufficient connections with a country to subject it to tax on its income attributable to the PE.

Place-of-incorporation test A rule under which a corporation is considered to be a tax resident of the country in which it is incorporated.

Place-of-management test A rule under which a corporation is considered to be a tax resident of the country in which it is controlled or managed (usually where the board of directors meets and exercises control over the affairs of the corporation).

Portfolio investment An equity or debt investment in a company that does not provide the investor with substantial influence in the management of the company. An equity ownership interest of less than 10 percent of the outstanding shares of a company is typically classified as a portfolio investment.

Profit-split method A method for the allocation of the worldwide profits of a multinational enterprise among its members in various countries in proportion to their contributions to the earning of the profits.

Residence country The country in which a person is resident for income tax purposes.

Residence jurisdiction A principle of taxation under which all income accruing to residents of a country (worldwide income), regardless of its source, is subject to tax by that country.

Resident A person who has sufficiently close connections to a country to be liable to tax there on worldwide income.

Saving clause A provision included in all US tax treaties that preserves the right of the United States, subject to certain exceptions, to tax its residents and its citizens as if the treaty had not been entered into.

Settlor of a trust A person who establishes a trust and usually transfers property to the trust.

Soak-up taxes Taxes levied by a country on nonresidents solely with the intention of those taxes being claimed by the nonresidents as credits against the taxes payable in their country of residence.

Source country The country where a foreign investment is located or where income arises.

Source jurisdiction A principle of taxation under which residents and nonresidents alike are taxed on income from economic activity within a particular country.

Subsidiary A corporation that is directly owned or controlled by another corporation. A foreign subsidiary of a corporation is a corporation resident outside the country of residence of the controlling corporation.

Tainted income Income of a controlled foreign corporation that is taxed to the resident shareholders of the corporation when earned by the foreign corporation rather than when distributed. Generally, tainted income consists of passive investment income and base company income.

Tax avoidance The deferral, avoidance, or reduction of tax by lawful means.

Tax evasion The reduction of tax by illegal means, usually involving fraudulent nondisclosure or willful deceit.

Tax havens Countries that subject income (or some forms of income) or entities (or certain entities) to low or no taxation.

Tax incentives or preferences General terms used to describe tax exemptions, deductions, credits, rate reductions, or other concessions designed to attract foreign investment or otherwise to affect economic behavior.

Tax sparing The allowing of a credit for the amount of foreign taxes that were not paid because of a tax incentive or holiday in the foreign country.

Territorial basis A method of taxation under a country imposes income tax only on income derived in that country (whether by residents or nonresidents).

Thin capitalization rules Restrictions on the deductibility of interest payments made by corporations with excessive debt-to-equity ratios to their substantial nonresident shareholders.

Tie-breaker rules Rules in tax treaties that establish the residence of a dual-resident taxpayer in one country for treaty purposes.

Trailing taxes Taxes imposed by a country after a person ceases to be a resident of that country that would not usually be imposed on nonresidents.

Transactional approach An approach for applying CFC rules under which only the tainted income (passive income and base company income) of a CFC is taxable to its resident shareholders.

Transactional net margin method (TNMM) A method for determining transfer prices in transactions between related parties, typically based on the ratio of profits earned by parties engaged in similar activities to some economic indicator, such as invested capital or gross receipts.

Transfer pricing rules Rules that limit the ability of related parties to set prices on transfers of property or services that are different from the prices that would be set in similar transfers involving unrelated parties.

Treaty override A term used (often in a negative sense) to describe a country's domestic legislation that takes priority over the provisions of a country's tax treaties.

Treaty shopping The use of a tax treaty by a person who is not resident in either of the treaty countries, usually through the use of a conduit entity resident in one of the countries.

Trust An arrangement allowed under the laws of common law jurisdictions for the holding of property by a person (trustee) transferred from a person (settlor) for the benefit of other persons (beneficiaries).

Trustee The individual or legal entity that has legal title to property and the power to manage that property for the benefit of other persons (beneficiaries).

UN Model Treaty A model income tax treaty sponsored by the United Nations that is based on the OECD Model Treaty, with some modifications made to reflect the interests of developing countries.

Withholding tax A tax levied by the source country at a flat rate on the gross amount of dividends, royalties, interest, or other payments made by residents to nonresidents. The tax is collected and paid to the government by the resident payer.

Worldwide basis A method of taxation under which a country taxes its residents on both their domestic source income and their foreign source income (i.e., their worldwide income).

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