International Tax Primer

THIRD EDITION

BRIAN J. ARNOLD

Wolters Kluwer

International Tax Primer

Third Edition

Brian J. Arnold

Wolters Kluwer

Published by:
Kluwer Law International B.V.
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.wklawbusiness.com

Sold and distributed in North, Central and South America by:
Wolters Kluwer Legal & Regulatory U.S.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@wolterskluwer.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

Printed on acid-free paper.

ISBN 978-90-411-5975-5

Printed in the United Kingdom.

International Tax Primer

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

Table of Contents

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