Principles of International Taxation

Fifth Edition

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Bloomsbury Professional Ltd, Maxwelton House, 41–43 Boltro Road, Haywards Heath, West Sussex, RH16 1BJ

Bloomsbury Professional, an imprint of Bloomsbury Publishing Plc

A CIP Catalogue record for this book is available from the British Library.

ISBN: 978 1 78043 785 9

Printed and bound by Hobbs the Printers, Totton, Hampshire

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Preface

We have both been teaching international taxation for more years than we care to remember, but have never found a book to recommend as reading to those who are fairly new to international taxation or indeed, are new to taxation in any guise. The principal aim of this book is to present the topic in an accessible manner, for university students, for those preparing for professional qualifications, and for practitioners generally.

With a shared commitment to providing readers with sound basic information, and guidance as to how best to further their knowledge of the subject, we first embarked on this project in 2006 with the aim of producing a text to underpin an introductory course in international taxation on a wide range of undergraduate and postgraduate degree programmes. We hope that the book will also prove useful to practitioners and policymakers who want to get back to basics and examine what lies beneath the current complexities of international tax rules, or perhaps to acquire a broader understanding of the principles. It is not our intention to produce a comprehensive legal reference work on the topic, since others have done this already, but rather to provide a solid foundation in the principles and policies of international taxation in generic terms, as well as an introduction to some UK-specific rules. To achieve this, we have tried to provide a blend of theory, policy and practical application for each of the topics under discussion. Additional reading is suggested within each chapter. This is drawn from a wide range of sources including, but not limited to, legal texts, practitioner and academic journal articles.

This book examines international tax principles primarily from the viewpoint of a multinational group of companies. However, where appropriate, the concerns of the tax authorities are addressed, and wherever possible we have advanced the reasoning behind the various anti-avoidance measures affecting international groups. The international taxation of high net worth individuals and trusts is not covered in this book, although we devote two chapters to the taxation of expatriate staff.

The fifth edition updates all the chapters as required, some of which are now in a different order, and significantly expands many of the chapters, particularly Chapter 9 (Permanent Establishments) and Chapter 11 (Overseas Expansion: Structuring and Financing). Throughout the book, new text examines developments in light of the OECD BEPS Project work. Rather than attempt to summarize the BEPS Project separately, we have integrated the BEPS recommendations into each chapter as appropriate, setting out the main recommendations, and offering some explanation and comment on these. The BEPS material includes the Final Reports issued by the OECD on 5 October 2015.

When preparing the fifth edition we have borne in mind the requirements of students preparing for the Advanced Diploma in International Tax (ADIT) as offered by the Chartered Institute of Taxation. These students may find the

'Further study' sections which we have appended to certain chapters to include more complex or detailed issues very useful, but students on more general courses of study could be advised that these sections are optional reading.

The book is in five sections. The first section is a brief introduction to taxation including the different forms that taxation may take and how tax systems are designed and administered, which can be skipped by those with some basic level of understanding of taxation in general. The second section is designed to introduce some key issues in international taxation, globalization, residence, source, double taxation and an introduction to double tax treaties. In the third section we consider what happens when one moves from doing business *with* another country to doing business *in* another country, and we begin to examine key features of the operation of double tax treaties. The fourth section expands on the third by examining the way in which differences in tax systems can be exploited by taxpayers to minimize global tax liabilities, and the measures adopted by governments to combat perceived tax avoidance. In the fifth and final section we examine the influence of the European Union on both direct and indirect taxation as well as some broad policy issues in the international tax arena.

Angharad Miller (lead author) & Lynne Oats
December 2015

Abbreviations

BEPS	Base erosion and profit shifting (BEPS Project)
CA	English Court of Appeal (from which appeal lies to the UK Supreme Court, and formerly to the UK House of Lords)
CON	Capital ownership neutrality
CIN	Capital import neutrality
CEN	Capital export neutrality
CRA	Canada Revenue Agency
CAFC	Court of Appeals for the Federal Circuit (from which appeal lies to the US Supreme Court)
CJEU	Court of Justice of the EU (formerly European Court of Justice (ECJ))
CPR	Civil Procedure Rules (rules that govern civil litigation procedure in England and Wales)
DTA	Double Taxation Agreement
DTT	Double Tax Treaty
EC	European Commission
EEA	European Economic Area (consisting of the EU plus Iceland, Liechtenstein and Norway)
EFTA	European Free Trade Area (Iceland, Liechtenstein, Norway and Switzerland)
EU	European Union (formerly the European Community)
FDI	Foreign direct investment
GATT	General Agreement on Tariffs and Trade
G8	Group of 8
G20	Group of 20
GST	Goods and services tax
HMRC	Her Majesty's Revenue & Customs
HL	UK House of Lords (replaced by UK Supreme Court)
IMF	International Monetary Fund
IP	Intellectual Property
IRS	Internal Revenue Service (the US tax authority)
LOB	Limitation on benefits
MNC	Multinational company
MNE	Multinational enterprise
MTC	Model Tax Convention (Treaty)
NN	National neutrality
NON	National ownership neutrality
OECD	Organisation for Economic Co-operation and Development
PE	Permanent establishment
R&D	Research and development
SRT	Statutory resident test

SPV	Special purpose vehicle
TFEU	Treaty on the Functioning of the European Union
TRIPs	Trade-Related Aspects of Intellectual Property Rights (administered by the WTO)
UN	United Nations
VAT	Value added tax
WIPO	World Intellectual Property Organization
WTO	World Trade Organization (administers TRIPs)

Glossary

Administrative costs	public sector or government costs incurred in administering the tax legislation and regulations.
Alienation	used in connection with the disposal of assets. The term includes sale, exchange, gift and other means by which a taxpaying entity or individual divests itself of an asset.
Alternative minimum tax	a special base level tax, usually computed as a percentage of gross income, imposed to combat tax minimisation by high income earners. Used in the US.
Anti-avoidance measures	measures to combat the avoidance of tax are found in taxation legislation as well as double tax treaties. They may be targeted at specific activities or in some cases a generic rule is used that disregards transactions entered into for tax avoidance purposes.
Arbitrage	taking advantage of inconsistencies between different countries' tax rules to achieve a more favourable result than would have resulted from investing in a single jurisdiction.
Arbitration	the settling of disputes by an independent person or group of persons. In international tax, the term is often used in connection with the settling of transfer pricing disputes by a group of persons somewhat independent of the taxpayer and tax authority.
Arm's-length principle	this term refers to unrelated parties dealing with each other wholly independently. Where parties to an agreement are related in some way, it may be that the price is not that which would apply if they were not so related. Tax legislation and double tax treaties often give the government power to substitute an arm's length price for tax purposes, for the actual price used between related parties.
Average tax rate	is derived by dividing taxable income by tax payable. This is sometimes referred to as the effective tax rate.
Beneficial owner	in common law countries the term is used to mean the persons who ultimately enjoy the benefit of an asset. Beneficial and legal ownership may be with different parties, for example in trust or agency relationships.

BEPS	base erosion and profit shifting: practices of multinational enterprises aimed at avoiding tax through exploiting differences in tax systems to achieve double non-taxation and through planning so as to have taxable profits located in low tax countries.
Bi-lateral	involving two states, for instance, a double tax treaty is a bi-lateral agreement.
Branch profits tax	many countries subject the profits of branches of foreign companies to an additional tax, so that they are treated in the same way as subsidiaries which generally pay withholding tax on profits distributed as dividends.
Broad based consumption tax	a generic term to describe consumption tax that applies to a broad range of goods and services, as distinct from narrow based which target specific items.
Capital export neutrality	this is where investors in the capital exporting country are subject to the same effective tax rate on income from domestic investment and income from foreign investment, that is the decision whether to invest at home or abroad is tax neutral.
Capital import neutrality	this is a term used by economists to describe the position where domestic and foreign investors receive the same after tax rate of return on similar investments in that market.
Capital gains (losses)	arise (are realised) on the disposal of assets and are the change in value of the asset between purchase and sale.
Civil law	body of law based primarily on statutes rather than judicial decisions.
Classical system	the classical system of company tax involves taxation of companies as separate entities and no allowance given to shareholders in receipt of dividend income for company tax paid.
Common law	legal system based on the common law of England, although different jurisdictions have developed differently, so it can't be assumed that all common law countries have the same approach to the law.
Company tax	or corporation tax is a tax on company income. Its tax base is corporate profits, which are generally different from the profits reported for other purposes such as under financial reporting rules.
Competent authority	under double tax agreements, both countries appoint a representative such as the Ministry of Finance to try to resolve disputes that arise from the operation of the treaty. The UK's competent authority is HMRC.

Compliance costs	costs incurred by taxpayers or third parties in meeting the requirements laid on them by the tax rules and regulations.
Controlled foreign company (CFC)	this term is used in the context of legislation aimed at preventing tax deferral by using companies in low tax jurisdictions, where the company involved is controlled by the country with the CFC legislation.
Consumption tax	a tax levied on the purchase of goods and services. Value added tax, goods and services tax, retail sales tax, and manufacture sales tax are examples of consumption taxes.
Customs duties	taxes on goods imported into a country.
Death duties	taxes imposed on property transferred on the death of the owner. Also referred to as inheritance taxes, estate duty, succession tax.
Depreciation	the allowable portion of the cost of the depreciable assets that are used up during an income generating activity that can be included in the cost of production.
Developing country	in this book, the term is used to denote any country classified as other than 'high income' by the World Bank. Thus the term includes low income, lower middle income and upper middle income states.
Direct taxes	are taxes which cannot be shifted from the legal taxpayer to the ultimate consumer of the good or service. Personal and company income taxes, payroll taxes and property taxes are usually considered to be direct taxes.
Dividends	distribution of profits by a company to its shareholders.
Domestic law	a state's own national laws.
Domicile	a person's domicile is his or her permanent home, the place to which he or she always intends to return.
Double non-taxation	can arise where a transaction involves more than one country and, typically, the payment leg of the transaction produces a deduction against taxable profits in the first country, but the receipt leg of the transaction is not taxed in the second country.
Double taxation	arises when the same activity is taxed more than once as in the case of taxation of distribution of corporate profits under a classical system of company tax.
Effective rate of tax	actual tax payable on the profits before taxation as shown in the financial accounts.
Energy tax	taxes on fossil fuels with a view to reducing emissions of carbon dioxide and other greenhouse gases.

Entity characterisation	the process of determining whether a commercial entity is to be recognised for tax purposes or whether the transactions which it enters into are to be treated as entered into by the individuals who have an interest in the entity.
Evasion	this is the illegal or fraudulent arrangement of affairs to eliminate or reduce tax liability.
Excise tax	a tax on the production of a particular good or services. It may be either a fixed rate (for example dollars per kilo) or ad valorem (varying according to the value for example X% per dollar). Cigarettes, alcohol and petrol are among the goods most commonly subjected to an excise tax or duty.
Exemptions	tax rules will often provide exemptions for particular people, items or transactions which would otherwise be taxed.
Force of attraction	under this 'rule' permanent establishments are taxed not only on income and property directly attributable to them, but also on all other income earned from sources in the country where the permanent establishment is located.
Foreign direct investment	investment into a state by a non-resident, such as the setting up of a factory as opposed to mere financial investment. The term can refer to either investment via setting up a foreign subsidiary or via a branch.
Foreign tax credit	a system for the relief of double taxation so that foreign sourced income of residents is taxed in the home country but then credit is allowed for foreign tax paid on that income.
Free capital	the amount of non-interest-bearing capital (typically share capital) a branch or subsidiary might be expected to have if it was an independent enterprise.
Gift duty	a gift is a gratuitous transfer of property during the donor's life. Many countries levy a gift tax on such transfers by reference to the value of the gift.
Immovable property	this term generally covers land and buildings.
Incidence of tax	the legal incidence is the point where tax is legally assessed. The effective or economic incidence refers to the ultimate bearer of the tax.
Income	this is a difficult concept to define, but it can generally encompasses employment income, business profits, rental income, interest.

Income taxes	income tax is a direct tax, usually imposed annually on the income of individuals and other entities such as companies.
Indirect taxes	taxes which can be shifted from the legal taxpayer to the economic taxpayer. Consumption taxes are usually deliberately designed to be indirect taxes.
Integration	in connection with company and personal income taxes refers to the process of taxing all company income at the individual's level using personal income tax rates.
Intellectual property	literary, dramatic, musical and scientific works are intellectual property which is protected by copyright, patent, registered design, or trademark. Payments for the use of intellectual property are referred to as royalties.
Jurisdiction	the authority to make law and to enforce it within a defined geographical area
Know-how	technical information necessary to reproduce a product or process.
Land tax	a tax assessed on the value of land, usually the annual rental value and may be with or without buildings.
Letter box company	a company which has complied only with the bare essentials for registration in a particular country, it really only exists on paper and doesn't actually conduct any activities.
Limitation on benefits	a tax treaty provision with the aim of preventing treaty shopping, which limits treaty benefits, for example reduced rates of withholding tax, to those who meet specified criteria.
Manufacturer's sales tax	is a single stage sales tax that is collected at the manufacturing level of the production/distribution process
Marginal tax rate	is the rate applicable to the last unit of the tax base.
Most favoured nation clause	a provision often found in double tax treaties whereby, typically, one state promises to reduce the rate of withholding tax charged under the treaty if, in future, it concludes a new treaty with any other state under which it charges a lower rate of withholding tax.
Multinational enterprise	company or group of companies with business establishments in two or more countries.
Neutrality	a principle which states that taxes should not affect the economic decisions of consumers or producers.

OECD	the Organisation for Economic Co-operative and Development is an organisation composed of representatives of the industrialised countries in Europe, the US, Japan, Canada, Australia and New Zealand. It was founded in 1961 and provides economic research and statistics and offers a forum for discussing and co-ordinating policies of common interest.
Opaque entity	an entity, such as a partnership which is viewed as a taxable person in its own right, independently of its members. The opposite would be 'transparent' where a state does not recognise the partnership for tax purposes at all but only the individual partners are recognised as taxpayers.
Partnership	an association of two or more persons. In some countries partnerships are treated as separate entities for tax purposes, in others they are not.
Payroll tax	a tax on the payroll or sums paid to employees.
Permanent establishment	this term is used in double tax agreements to determine whether a non resident has sufficient presence in a country to justify being taxed on the business profits it earns there.
Personal taxes	include all taxes paid by individuals, income, payroll, consumption and wealth taxes.
Poll tax	a per capita tax, or a tax per head of population, normally a fixed amount and not in common use.
Portfolio investment	a holding of shares in a company which is a small proportion of the total shares, usually less than 10%.
Profit shifting	the allocation of income and expenses between related organisations to reduce overall world wide tax liability.
Progressive tax	a tax by which the ratio of tax paid to income is higher for high income individuals than for low income ones. A progressive tax rate has a marginal rate which is always in excess of the average rate of tax.
Property tax	tax imposed on property ownership.
Regressive tax	is one by which the ratio of tax paid to income is lower for high income earners than for low income earners. The average rate of tax falls as income rises. Consumption taxes are often viewed as regressive as consumption is a larger share of income for the poor.
Residence	this is a common basis for the imposition of taxes, sometimes, but not always, defined in tax legislation.
Royalties	payments for the use of, or the right to use, intellectual property.

Schedular tax system	where income from different sources is taxed separately for example business profits, employment income, property income.
Special purpose vehicle	a legal entity set up to undertake a limited and specific transaction or set of transactions. Often used in treaty shopping.
State	a geographical area with a government and the capacity to enter into relations with other states. A sovereign state is not dependent on any other state or under the control of any other state. The term 'country' is often used interchangeably with 'state' but 'country' strictly only refers to the geographic area involved and could also refer to a non-sovereign state without the power to make law and enter into treaties.
Taxable income	the amount on which income tax is levied, usually defined by statute.
Tax base	the object to which the tax applies, for example, income, consumption or wealth.
Tax expenditures	is revenue foregone by a government as a result of special provisions of the tax legislation which, for example, grant preferential tax rates or exclude certain things from the tax base.
Tax havens	countries with very low or even nil tax rates on some or all forms of income.
Tax incentives	special provisions promote a particular activity such as investment in particular activities or geographical regions.
Tax incidence	is the ultimate distribution of the tax burden. The initial payer of the tax may be able to shift the burden of the tax to others (see direct and indirect taxes).
Tax shelter	is a provision of the tax legislation which allows individuals to reduce or eliminate tax liabilities, a form of tax expenditure.
Tax sparing	a special category of double tax relief in tax treaties to prevent tax incentives from being overridden by the treaty partner.
Tax treaty	is a treaty between nations concerning the tax treatment of income of each country's citizens and corporations which is generated in the other country.
Thin capitalisation	a company is said to be 'thinly capitalised' when it has a high ratio of debt to equity.

Transparent entity	an entity which is disregarded for tax purposes, the relevant taxpayers being the members of the entity. Some states treat bodies such as partnerships and certain types of company in this way.
Treaty override	occurs where a state gives priority to its national laws over its treaty with another state. Override can be intentional or non-intentional.
Treaty shopping	a tax minimisation (or avoidance) activity that entails setting up structures or arrangements in order to take advantage of a tax treaty with a third country, other than the country of residence and the country of investment of the taxpayer.
Underlying tax	tax on the profits of a company which pays dividends to a non-resident shareholder, which may be allowed as a credit under some systems of double tax relief.
Unilateral	one sided. for instance, double tax relief granted by a state in the absence of a double tax treaty with a state which has already charged tax on an income receipt would be unilateral relief.
Value added tax	VAT is levied on goods and services based on their increase in value as they move through the cycle from production to consumption. It is a form of multi-stage consumption tax.
Wealth taxes	are taxes based on the ownership of wealth and include taxes on real property, estate taxes and annual wealth taxes.
Withholding tax	a tax payable at the source where it is a final tax, ie a third party is charged with the task of deducting tax from certain payments and remitting it to the government.

Table of Statutes