source 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 source income of resident taxpayers. In contrast, inward-bound transactions typically involve a country's rules for taxing nonresidents on domestic source 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 and value-added taxes are particularly important. For example, 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. Similarly, the imposition of value-added taxes on supplies of goods and services, including digital goods and services, by foreign countries on domestic businesses and consumers raises important revenue and competitiveness issues. These important issues are beyond the scope of this primer, 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 of income tax described below. Often these goals conflict, so that a country must try to achieve a balance among 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 **internation 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 individuals' ability to pay (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. Although every country should care about the welfare of nonresidents, its primary duty is 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 and the competitive position of its resident enterprises in the global economy.

In the international context, countries compete. Tax competition is one way in which countries compete for 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, and many countries have adopted measures designed to discourage capital outflows (although their tax laws may also contain provisions that have the intended or 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 the income 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 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 just 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 nontaxation** 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 source 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 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 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, and 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 advisers. 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.

However, 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 their domestic tax on the foreign income. If T is entitled to a credit for foreign taxes imposed on her foreign income, she needs to be concerned about whether the foreign tax 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 the countries in which the multinational corporation carries on business or owns subsidiary corporations. Many countries, however, provide for certain corporate reorganizations to occur on a tax-free basis (or, more accurately, a tax-deferred basis, since any accrued gain or loss inherent in the transferred assets will be subject to tax when the assets are ultimately disposed of). 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 to give advice only on their domestic tax law, they must be sufficiently familiar with foreign tax laws to be able to recognize potential problems and 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 where income is earned by an individual, a **trust**, a partnership, a corporation, or some other legal entity. 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 rights and obligations 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.

Often, tax is 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 and in determining whether to reinvest or repatriate the profits from the investment. Tax advisers are expected to provide advice on the tax consequences of the various ways in which the profits of a foreign enterprise might be repatriated to the domestic corporation and to provide advice on 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:

- sell 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;
- sell its goods to an unrelated foreign distributor for resale to customers;
- establish a **branch** in the foreign country consisting of a warehouse and sales employees or agents to sell its goods there;
- establish a foreign sales subsidiary in the foreign country to sell the goods;
- establish a foreign holding company, which establishes a foreign sales subsidiary in the country to sell the goods; or
- license 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 and taxable entity, whereas a branch is a part or division of the resident corporation. As a result, when a resident corporation carries on its business 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 business activities. In contrast, if the foreign activities are carried out 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 those tax costs and benefits. Second, they 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, 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 payments included in its income. Assume, however, that the lessor is a resident of Country B, which treats financial leases for tax purposes as genuine leases. Under this assumption, 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 that are 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 (by the airline company in Country A and by the lessor in Country B) 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 profits attributable to sales outside Country A will be earned by THCo, not by ACo. Because THCo is a separate legal and taxable entity and because the tax advisers will ensure that it is not resident in Country A, the profits derived by THCo are not usually taxable by either Country A or Country TH. Thus, assuming that THCo's 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 its profits to be derived by ACo. Even if THCo actually performs selling and marketing functions, 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 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 the resident corporation 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 from the licensees into tax-exempt dividends paid to ACo; it 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.

1.5 INTERNATIONAL ORGANIZATIONS INVOLVED IN INTERNATIONAL TAX

Although sovereign nation-states are primarily responsible for establishing the rules of the international tax system through domestic legislation and tax treaties, other international organizations play an important role with respect to international tax. The four major international organizations involved in international tax – the OECD, the International Monetary Fund (IMF), the UN, and the World Bank Group – are described briefly in this section.

The OECD is unquestionably the most influential international tax organization. The Organisation for European Economic Co-operation (OEEC) was formed after World War II as part of the Marshall Plan for the reconstruction of Europe. It became the OECD in 1961, when Canada and the United States (US) joined the European

nations in the OEEC. Currently, the OECD consists of thirty-six member countries, most of which are wealthy developed capital-exporting countries.

The work of the OECD is conducted through various committees that operate by consensus. The relevant committee for tax issues is the Committee on Fiscal Affairs, which is composed of senior tax officials from the member countries. The Committee's work is supported by an administrative secretariat – the Centre for Tax Policy and Administration – which has a large staff (currently about 130 people from thirty countries) with expertise in various aspects of tax.

The regular work of the Committee on Fiscal Affairs is conducted through several working parties composed of senior tax officials from member countries. The current working parties and their areas of responsibility are as follows:

- Working Party No. 1 – the OECD Model Treaty and related treaty issues.
- Working Party No. 2 – tax policy and statistics.
- Working Party No. 6 – multinational enterprises and transfer pricing.
- Working Party No. 9 – consumption taxes.
- Working Party No. 10 – exchange of information and tax compliance.
- Working Party No. 11 – aggressive international tax planning.

Several nonmember countries have observer status and participate in the work of the OECD working parties on that basis.

The OECD Centre for Tax Policy and Administration also plays a leading role in other international tax initiatives that extend well beyond OECD member countries. These initiatives include forums to deal with specific international tax issues, and participation in these forums is available to all countries that are prepared to commit to the objectives of the forum. The Global Forum on Transparency and Exchange of Information for Tax Purposes has over 150 member countries; its work involves ensuring that member countries effectively implement international standards for exchange of information through peer reviews of the domestic laws and administrative practices of member countries.

In 2012, the Group of Twenty (**G20**) nations and the OECD began a joint project aimed at preventing **BEPS**. In 2013, the OECD released its *Action Plan on Base Erosion and Profit Shifting*, which set out an ambitious agenda with fifteen specific action items; the final reports were completed in October 2015 (available at www.oecd.org). The Forum on Harmful Tax Practices is responsible for ensuring that OECD member and nonmember countries eliminate their harmful tax practices in accordance with BEPS Action 5: 2015 Final Report (*Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*) through peer reviews of participating countries. The Forum on Tax Administration was established in 2002 to deal with all issues involving tax administration, with the goal of improving tax compliance; it currently has fifty members.

The **G20/OECD Inclusive Framework** was established in February 2016 as the institutional arrangement for implementing the BEPS package of minimum standards. The Inclusive Framework operates through a monitoring process and peer reviews, and is open to all countries that agree to implement the BEPS minimum standards;

currently, it has over 120 member countries. The Inclusive Framework is also responsible for supporting the preparation of a series of practical toolkits to assist developing countries in countering BEPS.

The World Bank Group was founded in 1944 and consists of five institutions and 189 member countries. It provides finance policy advice and technical assistance to developing countries, with the primary goals of eliminating poverty and promoting sustainable economic prosperity. The World Bank Group provides advisory services to individual countries on all aspects of tax policy and administration through its Global Tax Team.

The IMF was founded in 1945 and has 189 member countries. Its basic goal is to ensure the stability of the international monetary system, and its mandate extends broadly to economic and financial issues. The IMF provides loans to member countries, subject to conditions, to enable them to improve their financial positions. It also provides technical assistance to individual countries on economic, monetary, and tax issues, including tax policy advice, training, and legislative drafting.

Finally, the *UN* has been involved in international tax issues since the 1970s when it started work on developing a model tax convention for tax treaties between developed and developing countries. The first UN Model Convention – UN Model Double Taxation Convention Between Developed and Developing Countries (UN Model Convention) – was published in 1980 and revised in 2001, 2011, and, most recently, in 2017. The UN Model Convention is the responsibility of the UN Committee of Experts on International Cooperation in Tax Matters (the UN Committee of Experts), which is the successor to the UN Group of Experts that produced the original UN Model Convention in 1980. The Committee of Experts consists of twenty-five members nominated by their governments and appointed by the Secretary-General of the UN, with a majority from developing countries. The members serve for four-year terms in their personal capacity and not as representatives of their governments; however, in practice, many of the members adhere closely to their governments' positions. The Committee meets twice annually for four days, once in New York and once in Geneva. The meetings of the Committee are open not only to the attendees but also to the public, who can participate (but not vote) in the discussions. The meetings are regularly attended by representatives of UN member governments (other than governments with members of the Committee), other international organizations (the OECD and IMF), civil society, business organizations, and academics.

In addition, since 2012 the Capacity Development Unit of the UN Financing for Development Office, in conjunction with the UN Committee of Experts, has been active in providing technical tax assistance to developing countries in Asia, South America, and Africa and in developing practical materials to assist developing countries that have little experience in international tax. This work has focused on four main areas: transfer pricing, tax treaties, tax administration, and protection against tax base erosion. With respect to base erosion, the Capacity Development Unit has published three Practical Portfolios (toolkits) with detailed practical guidance for developing countries to use in analyzing their tax systems to identify the risks of base erosion and design appropriate countermeasures. These Portfolios deal with income from services,

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.

Where a resident of a country earns income derived outside the 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 the same income 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 result in double taxation and 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 nontaxation). These opportunities result from certain gaps in the residence and source jurisdictions of most countries and inconsistencies between the tax rules of those 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 their legitimate tax claims 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, in part due to the inability of source and residence countries to obtain information about transactions routed through tax havens. Until recently, tax havens had strict bank secrecy rules and similar nondisclosure 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 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 and for taxing nonresidents on their domestic source income, since 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, and driver's license);
- the individual's visa and immigration status; and
- the extent of the individual's actual physical presence in the country.

Under this test, the tax authorities of a country decide, based largely on 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 uncertain and 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 that have 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 deemed to be 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 (EU). 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.

Some countries consider individuals who have their domicile in the country to be resident there. 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. Domicile is mentioned in Article 4(1) of the OECD and UN Model Treaties as a ground for defining residence.

2.2.2 Residence of Legal Entities

The residence of a corporation is generally determined by reference either to its place of incorporation or to its place of management, or both. The **place-of-incorporation test** provides simplicity and certainty to the tax authorities and corporations and also allows corporations to freely choose their 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 US is a country that relies exclusively on a place-of-incorporation test.

For many corporations engaged in international operations, management activities may be conducted in several countries during any particular taxable year; as a result, the **place-of-management test** is less certain in its application than a place-of-incorporation test, at least in theory. 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 of the company (or the equivalent body with ultimate responsibility for and control of the affairs of a company) 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 purpose 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 or take advantage of certain 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 US 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; otherwise, the individual shareholders would not pay tax on the income earned through the corporation until they received dividends or sold their shares. 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 a 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 under either 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 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 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 pursuant to the **mutual agreement procedure (MAP)** in Article 25 of the OECD and UN Model Treaties. Most modern tax treaties follow the tie-breaker rules for individuals in the OECD and UN Model Treaties closely.

For legal entities resident in both contracting states, until 2017 the tie-breaker rule in Article 4(3) of the OECD and UN Model Treaties provided that the entity was a resident of the country where its place of effective management was located. According to the prior **Commentary** on Article 4, the place of effective management of an entity was 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 could have only one place of effective management, although it could have multiple places of management.

The place of effective management tie-breaker rule was often difficult to apply, was not viewed favorably by many countries, and was not used in many bilateral treaties. Most dual-resident entities are used 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. Therefore, many treaties provide that a dual-resident entity is not considered to be a resident of either country for most treaty purposes; as a result, such an entity is not entitled to any of the benefits of the treaty.

In 2017, Article 4(3) of both the OECD and UN Model Treaties was amended to provide that the competent authorities "shall endeavor" to establish the residence of a dual-resident legal entity taking into account its place of effective management, place of incorporation or creation, and other relevant factors. If the competent authorities cannot agree, the entity is not entitled to any treaty benefits except to the extent agreed by the competent authorities.

The US insists on the inclusion in its tax treaties of what is commonly referred to as a "saving clause" (and sometimes mistakenly referred to as a "savings 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.

In 2017, the OECD and UN Model Treaties were amended to include a similar saving clause in Article 1(3), providing that, subject to certain exceptions, "[T]his Convention shall not affect the taxation, by a Contracting State, of its residents."

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 where 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 also preclude the source country from taxing certain categories of income, even where 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 explicitly in domestic law or tax treaties. As a result, 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 meaningful guidance to taxpayers or tax officials.

The OECD and UN Model Treaties provide a mixture of implicit source rules and rules that function effectively as 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 oil or gas 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 where the resident carries on business through a **permanent establishment ("PE")** located in that other state (Article 7) and only to the extent that the profits are attributable to the PE. This rule is the functional equivalent of a source rule.

In general, under Article 5 of the OECD and UN Model Treaties, a PE is defined to be a fixed place of business, such as an office, branch, factory, or mine, and also includes a person acting on behalf of another person (a so-called dependent-agent PE) in some circumstances. However, these rules are subject to several exceptions and special provisions. For additional discussion of the definition of a PE for purposes of tax treaties, *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 to many countries in order to ensure that double taxation is eliminated and double nontaxation is not facilitated.
- They should allocate income and tax on a reasonable basis that is broadly acceptable to 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 that are generally applicable to employment and personal services income, business income, and investment income are discussed below. The source rules for these types of income 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

where 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 Article 5(3)(b) of 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 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 Article 5(5) and (6) are equally applicable to income from professional and independent services, as well as other business activities. Both of these issues remain unresolved under the UN Model Treaty because Article 14 does not contain any exception for preparatory or auxiliary activities or any special rules for agents.

In 2017, the UN Model Treaty was amended to add a new Article 12A to deal with the taxation of fees for technical services. Under Article 12A(2), where fees for technical services arise in a contracting state, that state is entitled to impose tax on the gross amount of the payment at a rate to be agreed by the contracting states. Fees for technical services are considered to arise in a state where the fees are paid by a resident or a nonresident with a PE in that state and the fees are deductible in computing the profits attributable to the PE. Fees for technical services are defined to mean consulting, technical, and management fees but do not include amounts paid to employees, amounts paid for personal services, and amounts paid for teaching in or by educational institutions. (*See* Chapter 9 for a more detailed discussion of the treatment of fees for technical services under Article 12A of 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. Where the employment is exercised in the source country, that country is entitled to tax the income from employment exercised in that country only if:

(1) the employee is present in the source country for 183 days or more; or
(2) the employee is paid by or on behalf of an employer resident in the source country; or
(3) the employee's remuneration is 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 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 source country 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 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 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. **Dealings** between a PE and the head office (notionally equivalent to transactions between separate entities) 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. US law 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, before the 2017 US tax reform, income from the manufacture and sale of inventory was apportioned equally between the country of manufacture and the country of sale, typically by a two-factor formula (sales and property). This source rule was eliminated in the 2017 tax reform and replaced by a rule that allocates all the income to the country in which the inventory is produced. 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 apportionment 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 for purposes of their withholding taxes on interest, dividends, and royalties. Under Article 11(4), where interest is deductible in computing the profits attributable to a PE, the interest is considered to arise in the country where the PE is located.
- Royalties paid with respect to intangible property are considered to arise in and are taxable by the country where the property is used and legal protection for the intangible property is provided. 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 for 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 rent 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 (for movable property that is industrial, scientific, or commercial equipment).
- 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.

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, under the sham transaction doctrine, 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 (GAARs). Specific anti-avoidance rules include transfer pricing rules, thin capitalization and earnings-stripping rules, controlled foreign corporation (CFC) rules, nonresident trust rules, FIF rules, and back-to-back or anti-conduit rules. GAARs 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 can establish 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 nonresident trusts, which are discussed in section 7.4 below.

Foreign investment fund rules. Several countries have adopted FIF 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 7.5 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 or 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** or **conduit 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 because ACo and the financial institution deal at arm's length. Back-to-back or anti-conduit rules are discussed in section 7.6 below.

Surplus stripping. The term "surplus stripping" is commonly used to refer to transactions whereby the surplus or after-tax profits of a corporation are effectively distributed to its shareholders in a form other than dividends or other taxable distributions. Surplus-stripping transactions can be purely domestic or cross-border (i.e., resident corporation with nonresident shareholders). In a cross-border surplus strip, the objective is usually the avoidance of withholding tax on dividends (which in many countries also applies to distributions on the liquidation of a resident corporation). Often, these transactions involve a sale of the shares of the corporation whose surplus is being stripped in order to convert dividends into capital gains, which will be

exempt from tax (perhaps because of the provisions of an applicable tax treaty). Countries may attempt to prevent cross-border surplus-stripping transactions through specific anti-avoidance rules or a GAAR.

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 its 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 extracting 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 1 million to finance its business activities. To provide that capital, NCo can either subscribe for 1 million in additional shares of RCo, or it can loan RCo 1 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 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.

All deductible interest payments by residents to nonresidents reduce or erode a country's tax base. However, not all base-eroding payments are objectionable; many deductible payments by residents to nonresidents, including interest, represent legitimate income-earning expenses.

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.

The statutory thin capitalization rules of countries differ considerably. In some countries, thin capitalization rules are seen as specific transfer pricing rules 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. Thin capitalization rules are discussed in section 7.2.2 below.

Under earnings-stripping rules, interest is considered to be excessive, and its deduction is denied if it exceeds a financial formula based on the earnings of the corporation (often 25–30 percent of earnings before deduction of interest, taxes, depreciation, and amortization, or "EBITDA"). The BEPS Action 4 Report recommended that countries adopt earnings-stripping rules in preference to thin capitalization rules. The BEPS Action 4 Report and earnings-stripping rules are discussed in section 7.2.3 below.

Some countries try to deal with the problem of excessive interest deductions by relying on administrative guidelines or practices. Still, others apply their transfer pricing rules or GAARs.

Excessive interest deductions are a problem not only where, as described above, interest is paid to nonresidents but also where interest expenses are incurred to earn exempt or preferentially taxed income. This situation often arises in countries that exempt income attributable to a foreign PE or exempt dividends from foreign corporations in which resident corporations own substantial interests. Theoretically, interest expenses on borrowed funds used to earn income that is not taxable should not be deductible. However, many countries allow the deduction of interest in these circumstances and even for countries that deny the deduction of interest, the rules for allocating interest expenses to sources of income can often be manipulated by taxpayers. The effect of allowing the deduction of interest in these circumstances is to provide a subsidy for foreign investment in foreign countries that impose tax at rates lower than the tax rate in the residence country.

Few countries deal with this problem directly. Australia and New Zealand have adopted so-called outbound thin capitalization rules under which resident companies are denied interest deductions to the extent that their debt exceeds a percentage (say, 75 percent) of the cost or value of their net domestic assets. Countries that have adopted earnings-stripping rules that apply to all interest expenses incurred by resident corporations, as described in section 7.2.3 below, may limit, but will not eliminate completely, interest expenses incurred to earn exempt foreign source income.

Another problem with interest expenses involves "debt push-down arrangements," which are often used in cross-border acquisitions to shift the debt used to acquire the shares of a corporation resident in a particular country to that corporation. Although debt push-downs can be accomplished in many ways, consider the following example. ACo, resident in Country A, is acquiring all the shares of BCo, resident in Country B. If ACo borrows the necessary funds to finance the acquisition, the interest on the borrowed funds will be deductible in computing ACo's income and reduce Country A's tax base. For a variety of reasons (e.g., ACo does not have sufficient income to absorb the interest deductions or the interest deductions are more valuable

because of the higher tax rates in Country B), ACo may wish the interest to be deductible against the profits of BCo in Country B. Therefore, ACo may cause the incorporation of a new company in Country B, Newco, to make the acquisition of the shares of BCo. ACo might use its borrowed funds to lend to Newco, and Newco could then use those funds to acquire the shares of BCo. The interest paid by Newco to ACo will be included in ACo's income but will be offset by its interest deductions. The interest paid by Newco to ACo would ordinarily be deductible by Newco. Since Newco is a holding company, it may not have any income against which to deduct the interest expenses. However, it may be possible for Newco and BCo to merge into one corporate entity, in which case the interest expenses will be deductible in computing the profits of the merged corporation. As a result, the interest expenses of Newco will be deductible against the profits of BCo.

Thin capitalization rules or earnings-stripping rules will limit the amount of interest deductions claimed by resident corporations through debt push-down arrangements; however, those rules are not targeted specifically at debt push-down arrangements and will not deny all interest deductions on such debt. Alternatively, some countries may adopt specific anti-avoidance rules or attempt to apply their GAARs in order to deny interest deductions resulting from inappropriate debt push-down arrangements.

7.2.2 The Structural Features of Thin Capitalization Rules

Typically, thin capitalization rules (and earnings-stripping rules that are targeted at interest paid to nonresident shareholders of domestic corporations) have most of the following structural features.

Nonresident lenders. Thin capitalization 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, as noted above, some countries, such as Australia and New Zealand, also apply their rules to resident corporations that use debt to finance foreign investment (so-called outbound thin capitalization rules). In contrast, as discussed below in section 7.2.3, the earnings-stripping rules adopted by European countries and the US apply to interest paid to 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 nonresidents 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 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 and paid to a controlling or substantial shareholder – 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.

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?

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. Therefore, some countries' thin capitalization rules contain provisions that attempt to prevent the use of back-to-back loans and similar tax avoidance devices. *See* section 7.6 for a discussion of back-to-back or anti-conduit rules.

Thin capitalization rules focus on payments of interest 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, as described below in section 7.2.3, in 2016 the EU issued an anti-tax avoidance directive requiring EU countries to adopt earnings-stripping rules that apply to all interest payments by resident corporations, including such payments to residents.

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. In periods of low-interest rates, corporations can carry more debt than in periods when interest rates are high. Thin capitalization rules based on a fixed debt:equity ratio apply irrespective of whether interest rates are high or low. This difficulty can be dealt with by adjusting the debt:equity ratio periodically to reflect significant changes in interest rates.

7.2.3 Earnings-Stripping Rules

The BEPS Action 4 Final Report rejects thin capitalization rules in favor of earnings-stripping rules, largely because, according to the Report, earnings provide a better measure of an entity's ability to meet its interest obligations, and also because, as noted above, thin capitalization rules do not take interest rates into account. In contrast, 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.

The recommendations in the BEPS Action 4 Report are not mandatory; countries may or may not choose to adopt them. However, the EU and the US have adopted earnings-stripping rules similar to the rules recommended in the Report.

In simple terms, the major features of the earnings-stripping rules recommended in the BEPS Action 4 Report are as follows:

> The rules would apply only if an entity's interest expenses exceed a *de minimis* monetary threshold, which is intended to reduce the administrative and compliance burden of the rules. The EU Directive establishes a *de minimis* threshold amount of 3 million Euros, which must be allocated among the members of a multinational group.

An entity would be permitted to deduct its net interest expense up to a benchmark ratio of its net interest expenses (interest expenses in excess of interest income) to EBITDA. An entity's net interest expenses and EBITDA would be calculated in accordance with a country's tax rules, not its financial accounting rules. The benchmark ratio would be set within a range of 10 to 30 percent of an entity's EBITDA. Both the EU and the US have adopted a benchmark ratio of 30 percent of EBITDA although the US rules will move to a ratio based on EBIT after 2022. Interest expenses in excess of the allowable amount would not be deductible but could be carried over to past or future years.

The rules would apply to an entity's net interest expense (its interest expenses in excess of its gross interest receipts) in order to accommodate intergroup payments of interest.

As an optional relief measure, an entity would be allowed to deduct interest expenses in excess of the allowable percentage of its EBITDA if the net arm's-length interest expense to EBITDA ratio of the multinational group of which the entity is a part is greater than the entity's ratio. The rationale for this alternative worldwide group rule is that if a resident entity is leveraged at a ratio approximating the global group's leverage ratio, the base erosion resulting from the interest deductions claimed by the

resident entity is acceptable and not excessive. The optional worldwide group rule requires taxpayers to assemble, and tax administrators to audit, the financial information with respect to the multinational group as a whole; it would be necessary to use financial accounting information rather than tax information for this purpose. The EU earnings-stripping rules allow entities that are part of a consolidated group to deduct their excessive interest up to the group's ratio of net interest expense to EBITDA. Further, an entity is entitled to deduct all its interest expenses where the entity's equity to total assets ratio plus 2 percentage points is equal to or higher than the equivalent ratio of the group as a whole. The US earnings-stripping rules do not provide any worldwide group relief rule.

The rules are intended to apply to interest and all other payments that are economically equivalent to interest, applying an economic substance approach.

The application of earnings-stripping rules to domestic entities that are not part of a multinational group is optional. If the rules are not applied to such stand-alone entities, they would be entitled to deduct all their interest expenses.

Entities are allowed to carry over disallowed interest expenses to past or future years as well as carry forward any unused interest deductibility room from one year to future years.

An exception for interest expenses incurred to finance long-term public benefit projects could be adopted as long as the project is financed with nonrecourse debt, the income from the project is subject to tax, and the borrowed funds are not loaned to another entity. The EU rules provide an exception for long-term public infrastructure projects that are in the general public interest.

Countries may wish to adopt targeted rules to prevent artificial arrangements and to address the special considerations of financial services and insurance companies. Examples of targeted anti-avoidance rules include thin capitalization rules and rules to deal with back-to-back financing arrangements.

Unlike most countries' thin capitalization rules, the earnings-stripping rules recommended in BEPS Action 4 and adopted by the EU and US apply to all interest expenses of resident entities, subject to certain narrow exceptions, rather than just to interest paid to nonresidents. Thus, these earnings-stripping rules are targeted at the deduction of excessive interest expenses generally, not at cross-border base erosion specifically. As noted above, the reason for the broad application of the EU earnings-stripping rules is to avoid any conflict with the nondiscrimination protections of EU law. Other countries may also decide to adopt broad earnings-stripping rules to avoid any conflict with the Non-discrimination article of their tax treaties. Under Article 24(4) and (5) of the OECD and UN Model Treaties, one contracting state is prohibited from treating interest (and other disbursements) paid to residents of the other contracting state less favorably than similar payments to its own residents and from treating resident corporations owned or controlled by residents of the other contracting state less favorably than other resident corporations. The Non-discrimination article of the OECD and UN Model Treaties is discussed in Chapter 8, section 8.8.1.

One important advantage of an earnings-stripping rule is that if a multinational group of companies shifts profits from a high-tax country to a low-tax country, the deduction of interest against the high-tax country's tax base is reduced accordingly.

One serious problem in restricting interest deductions on the basis of earnings is how to deal with situations in which an entity has a loss for a year. Typically, interest is deductible whether or not taxable income actually results from the use of the borrowed funds. It is generally accepted that it would not be good tax policy to make interest deductions dependent on the actual production of income because that would discourage taxpayers from engaging in risky ventures. Therefore, to avoid penalizing businesses that are very risky or are cyclical in nature, countries can provide a carryover for any disallowed interest.

The selection of a specific percentage of earnings as an allowable limit for interest deductions is arbitrary. The objective is to allow deductions for all the arm's-length third-party interest expenses of a multinational group that are reasonable costs of doing business but to disallow deductions for interest expenses that are excessive and represent an unacceptable erosion of a country's tax base. Most countries have adopted a limitation of 25 to 30 percent of earnings.

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 easily be 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, because either the interest is not sourced in Country A or 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. Where a foreign subsidiary distributes dividends to its resident parent corporation or 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 2018, 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 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.

In 2017, the US took the extraordinary step of imposing a minimum tax of 10.5 percent (increasing to 13.25 percent in 2026) of the income of CFCs of US taxpayers in excess of a deemed 10 percent rate of return on a CFC's tangible assets. The income subject to this new minimum tax is called "global intangible low taxed income" or GILTI. Thus, income of a CFC that is not subject to the full US corporate tax rate under the Subpart F rules (most active business income) will be subject to this minimum tax, and only 80 percent of the foreign tax paid by the CFC on that income is creditable against the minimum tax.

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 entities 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) or 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 a resident has a substantial ownership interest (20 percent in the case of Brazil and 25 percent in Portugal and Denmark). 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 usually includes indirect control. Thus, 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. 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 nontax haven countries without any statutory definition of what constitutes a tax haven. 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. In contrast, under the global approach, the residence of the foreign corporation is irrelevant; the rules apply on a worldwide basis, but only to specific categories of income. 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.

The general definition of a tax haven is invariably based on a comparison of the taxes levied in the foreign country and 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 provided 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 necessarily mean that a particular CFC resident in that country may not be subject to low foreign taxes. Although some countries use the effective-tax-rate approach, most countries 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 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. It should be noted that 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 nontax 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 nontax 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 nontax 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 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 directly by the parent of the CFC.

(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 relying on the application of 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 exemption or 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 related 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 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 3,800 as of late 2018 – 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.

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, most countries allow a credit for the foreign tax paid by a CFC on the income that is taxable in the hands of a resident shareholder. The possibility of double taxation also arises where the CFC's income is subject to foreign tax and a shareholder receives dividends from the 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 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 to the extent that the gain is attributable to the previously taxed income of 900. 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 MAP 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. (Note that, as of 2017, Article 1(3) of the OECD and UN Model Treaties confirms the principle that tax treaties do not restrict countries from taxing their own residents.)

The strength of these arguments varies depending on the particular country's CFC rules and the specific provisions 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 FIFs allow resident taxpayers to defer domestic tax on their passive investment income. FIFs 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 FIFs. For some countries, the purpose of these rules is to prevent the avoidance of CFC legislation. For some other countries, the FIF 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 FIF rules, it is useful to compare the tax consequences of three alternative investments: (1) an investment in a FIF; (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 FIF 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 annually on the income derived by a domestic investment fund.

The benefit of an investment in a FIF 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 FIFs 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 FIF rules form part of the CFC rules. The CFC rules apply to small investors in foreign corporations and other entities controlled by residents where 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 FIF. Thus, residents who hold an interest in a FIF 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 FIF 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 FIF is actively traded on a stock exchange or 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 FIF 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 FIF. 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 FIF's income. As a result, it is sometimes limited to taxpayers who own a substantial interest in the offshore entity.