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INTERNATIONAL COMMERCIAL TAX

PETER HARRIS AND DAVID OLIVER

Introduction

Tax law is a dynamic area where politics, law, economics, commerce and accountancy intersect. It is renowned for its complexity and intricacy; typically the income tax law (or general tax code if applicable) is the longest law that a country has. At least in Britain, this has been the case for centuries.[1] Tax law in practice is never pure from a conceptual or theoretical perspective. It is a fascinating mix of history, compromise and political rhetoric. Unlike other areas of law, where academic literature strives to uncover controversial and challenging issues, tax law is rife with *fat and juicy* issues. The challenge in the tax law field is securing agreement on any particular issue. Any change to a tax law almost inevitably involves winners and losers and so all tax reform is controversial.[2] Added to this, the most important modern taxes are broad based and touch nearly every dealing, every interaction of life. Tax law is, therefore, necessarily a reflection of life. In this era of globalisation, the information age and the never-ending search for greater efficiency, our lives have become increasingly complex. So has tax law.

While any tax law book must struggle with these types of issues, an international tax law book takes on further dimensions. The international extension involves dealings taking place across international borders. As such, the participants in the dealing face not one but two systems of tax law. In addition, the participants face the interaction between the two systems, often in the form of tax treaties, and sometimes, such as within the European Union, a supra-national level of law. Finally, by its very nature a cross-border dealing is often (likely) undertaken by sophisticated market players such as multinationals and so the dealing is complex of itself. These extra dimensions make the study and analysis of international tax law much like the proverbial

[1] See Harris (2006, p. 58) referring to the length of English direct tax laws dating to the sixteenth century.

[2] Hence the adage that *an old tax is a good tax*.

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onion. Care must be taken in dissecting each of the different layers if a full appreciation of the overall position is to be attained.

The primary purpose of this book is to act as a guide, a mind map in dissecting international tax law issues. It seeks to do so by investigating and analysing the different systems of income tax rules that interact and sometimes clash in the context of international commercial transactions. It identifies the circumstances in which two or more sets of income tax laws may clash, explains why clashes arise and sets out options for resolving clashes. The book takes account of both theoretical and practical considerations in evaluating whether to resolve any clash, if so, how any clash should be resolved and how clashes are resolved in practice (whether by agreement between governments or by the actions of taxpayers).

The book adopts a detailed conceptual structure that is intended to promote lateral thinking. It draws on particular bodies of legal rules as well as practical examples to illustrate the structure and demonstrate how international tax law *works* in practice. The main body of legal rules that attempts to resolve the clash of two or more income tax systems is bilateral double tax treaties based on the Organisation for Economic Co-operation and Development's Model Convention on Income and Capital (the OECD Model).[3] In recent years, European Union Law (EU Law) has become increasingly important in resolving international tax issues within the European Union (the EU).[4] The influence of this body of law has been recognised outside the EU, because the EU is viewed, to some extent, as an accelerated version of where globalisation is leading. So EU Law applicable to direct taxation is also considered, where relevant, both because of its independent importance and as a point of comparison with the OECD Model, highlighting consistencies and peculiarities of each body of law.

The OECD Model does not comprehensively regulate many important international tax issues and has not been adopted by countries on a uniform basis. So a further purpose of this book is to analyse the limitations inherent in the OECD Model and identify how tax treaties diverge from the Model in practice. Interaction between tax treaties and EU Law is another theme of this book. The book also seeks to highlight and analyse how the limitations of tax treaties and their divergence simultaneously give rise to potential double taxation as well as international

[3] OECD (1992–).

[4] European Union Law is that based on or under the Treaty on European Union and the Treaty on the Functioning of the European Union (FEU Treaty), both of which came into effect on 1 December 2009, following ratification of the Lisbon Treaty. These treaties amend and consolidate treaties dating back to the 1950s.

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tax planning opportunities. Double tax treaties (and EU Law) overlay domestic tax law, which also fills any gaps in them. This book considers the interaction and integration between domestic tax law and double tax treaties (and EU Law). Where domestic tax law is relevant, reference is made to United Kingdom (UK) tax law as illustrative. If UK tax law is not illustrative, then the tax laws of other countries may be referred to.

As will be seen from the above, there are a number of limitations inherent in the scope of this book. First, it is limited to a consideration of income tax.[5] Second, it does not seek to cover all international income tax issues. Rather, it focuses on those issues arising out of commercial transactions. Further, it does not purport to be comprehensive in its reference to legal provisions, treaties, case law or academic literature. Many works provide a detailed consideration of the various levels of law referred to in this book.[6] The focus is on the OECD Model, using EU Law as a point of comparison. So other model tax treaties, such as that of the United Nations (UN) or the United States (US), are not referred to unless they provide a unique illustration of a particular point.[7] In all these matters, the focus is on illustrating and analysing how international tax law works in practice while providing sufficient references to facilitate more detailed research into particular issues.

The book comprises seven chapters. It begins by setting the scene with a number of important preliminary matters. Chapter 1 discusses relevant fundamentals of an income tax. It does not discuss all the fundamentals of income taxation, but rather focuses on those that are particularly important when projected into an international setting. As this introduction has already demonstrated, there are a number of important sources of international tax law. Chapter 1 proceeds to identify the relevant sources and consider how they interrelate. These sources are quite different in their nature and form. The approach to interpretation of them may be different

[5] Some countries, such as the UK, limit a reference to 'income tax' to the taxation of income of individuals, or entities other than corporations, the tax on corporate profits being referred to as 'corporation tax'. This book uses the term 'income tax' to include any tax on corporate profits.

[6] For example, as regards the OECD Model, see Baker (2001–); as regards the application of EU Law to direct taxation, see Terra and Wattel (2008); and as regards UK income and corporation tax, see Tiley (2008).

[7] Regarding the UN Model, see United Nations (2001). Regarding the US Model, see United States (2006). van Raad (2009) is a useful publication that contains these Models, as well as the OECD Model and Commentary, various OECD papers and drafts, other important international material, relevant FEU Treaty provisions and EU Directives together with relevant direct tax decisions of the European Court of Justice.

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depending on the source and the forum doing the interpreting. The general approach to interpretation of material is the final matter considered in Chapter 1.

Chapter 2 looks at the big picture, the justification or jurisdiction to tax in an international setting. It identifies separately the importance of the person and their activities within the concept of economic allegiance and how, in the context of an income tax, the concepts of residence and source are used as proxies. The chapter proceeds to discuss the situation of divided allegiance (primarily where source and residence are in different countries) and the problem of double taxation that arises. This discussion takes account of broad principles that underlie and limit cross-border taxation, including non-discrimination, inter-nation equity, source-country entitlement and reciprocity of withholding tax rates. Comparable principles that underpin EU Law are also considered. The principles are only outlined at this stage; they are used in detail throughout the book in practical examples.

Chapter 2 is critical for the purposes of this book because it develops the *Base Case* upon which much of the remainder of the book is structured. The *Base Case* is illustrated in Figure 1. It considers the simple scenario in which a person (Allan) in one country (Country A) rents a property in that country that is owned by another person (Beth) in a second country (Country B). Allan pays rent to Beth, i.e. a cross-border payment.

Focusing on this simple scenario facilitates a breakdown of the primary types of issues faced in international taxation. As mentioned, international tax at the least involves the application and interaction of two tax systems. In the *Base Case*, these are the tax systems of Country A and Country B. The tax system of Country A (the source state) is considered in Chapter 3 and the tax system of Country B (the residence state) is considered in Chapter 4. These chapters are the central basis of the book. Both have a similar format in that they consider the tax treatment of Beth, i.e. the person receiving the rent, and subsequently proceed to consider the tax treatment of expenses, i.e. the treatment of Allan in Country A with respect to paying the rent and that of Beth in Country B with respect to any expenses incurred in Country B in deriving the income. In this context, each chapter considers the relevant rules in tax treaties, EU Law and, where relevant, underlying domestic law. Within this primary structure, the content of the two chapters is very different.

Chapter 3 proceeds to consider source-country taxation of our income recipient, i.e. Beth. The structure broadly follows that of the OECD Model and so is schedular in nature, dealing with different types of income

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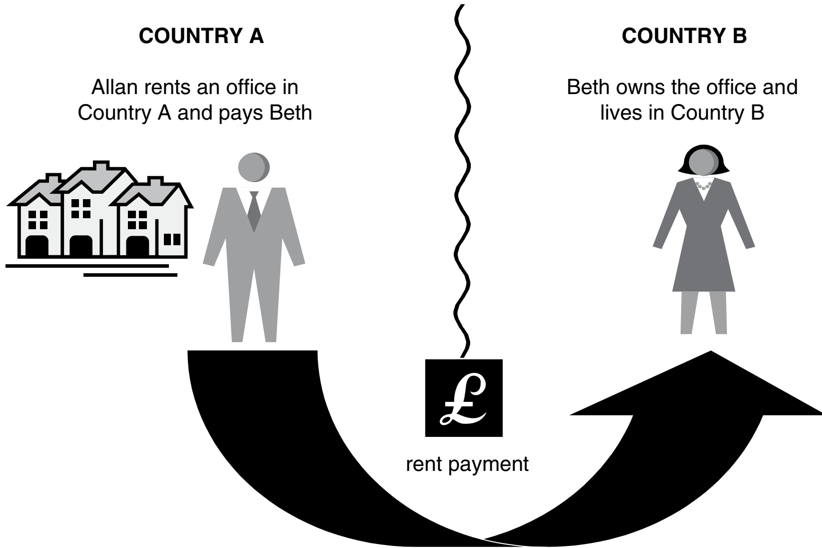

separately. While structured around the OECD Model, at the end of the consideration of each type of income there is a consideration of how source-country taxation may be affected where the country is a member of the EU, i.e. an evaluation of how EU Law might alter the treatment by the source country. EU Law is considered in a similar manner throughout the book. Chapter 3 proceeds to consider the treatment of the payer by the source state. This is primarily a consideration of any rules that may affect the deductibility of the payment by the payer (Allan) in the source country. The chapter then reflects on some income tax fundamentals (identified at the start of Chapter 2) that have a substantial impact on source-country taxation. Within this context the discussion considers the difficult issues of transfer pricing and thin capitalisation.

Chapter 4 switches to the residence or home state of the income recipient, i.e. Country B. It presumes taxation of the recipient (Beth) by the source state (Country A) in accordance with the rules and considerations outlined in Chapter 3. It begins by looking at the likely response of the residence state under its tax law to taxation by the source state, i.e. it outlines methods of foreign tax relief. These are primarily the exemption and foreign tax credit methods and each gives rise to problems in calculating foreign income, essentially an issue of deductibility of expenses. The chapter then turns to consider particular problems that arise where the

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income is derived through a corporation in the source state. These include the risk of economic double taxation and methods to relieve it as well as potential deferral of residence-state (Country B) taxation and the use of controlled foreign corporation rules to prevent any deferral.

Chapter 4 then dissects the difficult issue of expenses incurred in deriving foreign-source income. This initially involves the allocation of expenses between domestic income and foreign income but it proceeds to consider the situation where the expenses give rise to losses. The use of losses in a cross-border scenario is particularly problematic because of the lack of treaty rules regulating the scenario. At this point the comparison with EU Law is particularly instructive because EU Law has much greater scope for regulating the situation. The chapter ends with a consideration of the use of losses by international groups of corporations.

As mentioned, tax treaties do not regulate all income tax issues arising in a cross-border scenario. Chapters 3 and 4 consider the rules that do exist. By contrast, Chapter 5 focuses on the limited scope of tax treaties, i.e. issues treaties do not cover. It begins by continuing the focus on the simple bilateral situation, i.e. the *Base Case*. It returns to some of the income tax fundamentals outlined in Chapter 2 and considers what happens if there is disagreement between the two countries about some of these fundamentals. The consequence of disagreement is potential double taxation or potential non-taxation, but in this increasingly integrated world, the potential is that a given cross-border dealing is not simply bilateral but will involve three or more countries. Issues arising in this sort of scenario are the focus of the second part of Chapter 5. In practice, the issues are highly complex, but it is hoped that the foundations set by the preceding chapters will enable readers with even little tax experience to grapple with the conceptual issues and secure a basic understanding of the practical rules.

As mentioned, Chapter 2 identifies separately the importance of the person and their activities in founding taxing rights. Chapters 3, 4 and 5 presume the location of the person and their activities is constant. By contrast, Chapter 6 considers the consequences where there is an establishment or relocation of the elements giving rise to the fundamental right to tax. It discusses a number of issues that keep international tax practitioners busy (and make them a lot of money). The chapter begins by considering changes in the activity that produces income. In particular, it considers the tax treatment in both the host (source) and home (residence) countries when a foreign business (activity) is established. It then similarly considers situations where an existing foreign business

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is terminated, is transferred and where the form of a foreign business is changed (e.g. from a branch into a subsidiary). The chapter then turns to consider changes in the location of the person, i.e. the tax consequences of commencing or ceasing residence.

Chapters 3 to 6 consider the primary rules that regulate international taxation. Of course, those rules must be administered. In large part the domestic tax law of the countries concerned will regulate this administration. This is not a book about tax administration. However, there are a number of tax administration issues that are peculiar to the cross-border integration (clash) of tax systems and these are reflected in tax treaties. Chapter 7 considers three of these. The first involves the power of the tax administrations concerned to exchange information about a cross-border dealing or, indeed, specifically collect information for the other tax administration. The second involves how to resolve issues where the tax administrations of the countries concerned do not agree on what is the appropriate treatment of a particular cross-border dealing. Here the discussion considers the mutual agreement procedure and arbitration. The final issue involves the power of one tax administration to assist the other in collecting its taxes.

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Fundamentals and sources of international tax law

The purpose of this chapter is to outline background material that is important in later discussions. It is structured under three headings. The first considers some tax fundamentals that identify the nature of income tax and its basic attributes. As mentioned in the introduction, the purpose of this heading is to identify a number of income tax fundamentals that are important when projected into an international setting. The second heading proceeds to identify the sources of law that will be referred to and analysed in the remainder of this book. The focus is primarily on three sources of law – domestic law, tax treaties and EU Law – although residually a number of others are mentioned. The heading considers how these sources take effect in domestic law and how they interact with each other. The last heading considers the approach to interpretation of the sources by relevant courts. Here the focus is on the approach to interpreting treaties, which may be substantially different from that used for interpretation of domestic legislation. Also of particular importance is the jurisprudence of the European Court of Justice, the central court appointed to interpret EU Law.

1.1 Tax fundamentals[1]

A responsible government is one that is elected to represent its community members. It is a basic premise of the relationship between community members that they will share the burden of funding their common government. Taxes are the way in which those community members are, at least initially, obliged to share that burden. More particularly, taxes are a compulsory contribution levied by government to raise funds to be spent for public purposes (public services), including the support of the government. At some level, if there were no taxes there would be no

[1] For a more detailed consideration of tax and particularly income tax fundamentals, see Harris (1996, pp. 1–37).

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government. In the words of the famous American judge Oliver Wendell Holmes, '[t]axes are what we pay for civilized society'.[2] The result is an economic or financial relationship between community members and their government.

However, not all government levies are taxes. It can be particularly important to distinguish taxes from other levies where the word 'tax' is referred to in a constitutional document, as it is, for example, a number of times in the FEU Treaty.[3] Taxes are often distinguished from a governmental charge for services. With a charge for services there will be an identifiable service provided for the payment. There is a big difference between a road toll paid to use a new road and paying tax for the general defence of the country. Further, the charge must vary in some respect to the service received and not according to some general notion of ability to pay. There must be some connection between the cost of the service to be provided by the government and the amount of revenue to be raised (but a reasonable profit is okay). A UK example of a charge for services is the television licence, which funds the British Broadcasting Corporation (BBC).[4]

Having identified what a tax is, wealth is an important concept in identifying the main types of taxes that governments rely on. Perhaps the reason for this importance is that taxes are payable from wealth, inevitably in money, although this was not always the case.[5] The fact that tax is payable in money, local currency, causes problems which impact on tax design. These will be returned to shortly. Governments often impose taxation by reference to the stages of wealth: creation, holding, transfer and consumption (destruction). The major example of a tax on the creation of wealth is the income tax. Taxes on the holding of wealth were once common in Europe but have been in decline for a number of years. The major example of a tax on the holding of wealth in

[2] *Compania de Tabacos* v *Collector of Internal Revenue* (1927) 275 US 87 (SC) at p. 100.

[3] The word 'tax' is used in the FEU Treaty in, among other provisions, Art. 65(1), which is one of the provisions dealing with acceptable limitations on the free movement of capital and Part three Title VII Chapter 2 (Arts. 110–113), which deals with tax provisions.

[4] For an example of a licence fee held to be a tax and therefore invalid without sanction of Parliament, see *AG* v *Wilts United Dairies* [1922] All ER 845 (HL). Generally regarding the difference between a tax and a charge for services, see Tiley (2008, p. 4).

[5] Historically, contributions to support government might have been made by the provision of labour (often called 'statute labour'), an English example of which is the knight's fee. Particularly in colonial times, taxes might have been paid in local produce, such as corn, tobacco or even alcohol. Generally see Harris (2006), especially at pp. 16, 84, 144 and 478.

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the UK is now the local land rate. Taxes on the transfer of wealth include stamp duties and inheritance tax. The value added tax (goods and services tax in some countries) is often viewed as the major example of a tax on consumption, although its name might suggest that it is a tax on the creation of wealth.[6]

Taxes on the stages of wealth each have a relationship one with the others. This is important because it assists in understanding that there are many issues common to all of the major taxes imposed by a certain country. In particular, a tax on the creation of wealth, such as the income tax, is related to each of the other stages of wealth. Wealth once created may be used in only one of two ways, saving or consumption. Saving results in the holding of wealth and often wealth held itself creates further wealth, e.g. in the form of rent. Taxes on wealth held and on the return on wealth held often produce similar results. If all wealth created is consumed, an income tax and a consumption tax will produce the same result. Many income taxes in practice provide concessionary treatment of some forms of saving (particularly in the context of saving for retirement) and so blur the line between an income tax and a consumption tax.

An income tax is also related to taxes on the transfer of wealth. This is because the transfer of wealth is a realisation event upon which the income tax is typically based.[7] The income tax does not seek to tax all creations of wealth but typically only those that have been 'realised'. Realisation is a particularly slippery but important concept in income taxation. While there is no perfect definition of what realisation involves, it is clear that it has its origins in the history of accounting.[8] For present purposes, it is enough to suggest a realisation involves an exchange with another person and the exchange will typically involve a payment.[9] Therefore, a realisation-based income tax taxes creations of wealth accruing to a person only when and if they are transformed by a payment by another person. In this way, payments become the building blocks of the income tax base. Payments received count positively towards the calculation of income

[6] Whether a value added tax is a tax on the creation or consumption of wealth depends on the timeliness with which excess input tax credits are refunded and how consumption is defined (purchase by end user or actual destruction of wealth).

[7] This relationship is especially clear in the context of a tax on capital gains. The UK seeks to integrate, to some extent, capital gains on death and the imposition of inheritance tax, for example see TCGA 1992 s. 260.

[8] See the discussion in Harris (2006, pp. 135, 393–4 and 401).

[9] Adam Smith once noted: 'The goods of the merchant yield him no revenue or profit till he sells them for money, and the money yields him as little till it is again exchanged for goods' (1776, book II chapter I p. 133).

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