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Taxing Cross-Border Business Income

1.1 What Is Cross-Border Taxation?

1.1.1 Introduction

Cross-border trade is the flow of goods and services across the international borders of different jurisdictions. Taxation is the levy, which may be either direct taxation (income taxes, estate taxes, gift taxes and social security contributions) or indirect taxation (consumption taxes such as value-added or goods and services taxes, sales taxes and customs duties), imposed by sovereign countries to fund their public goods and services in the areas of, amongst other things, law and order, health care, infrastructure, education and security. In most countries revenue raised from taxation is redistributed to support various members of society such as the elderly, those with young families, the sick and the poor.

Cross-border business income taxation is, therefore, that form of taxation:

1 Where the resident of a jurisdiction is doing business overseas and the jurisdiction concerned decides to impose taxation on the resident. The taxation of this overseas income is sometimes complicated because another country’s tax laws may apply to this income (see point 2) and this will have consequential implications in the resident’s jurisdiction (outbound investment). The key concept applicable to this outbound investment income is the concept of residence because it is upon this concept that the jurisdiction imposing taxation bases its claim.

2 Where the government of one country taxes the business being carried out in its jurisdiction by a non-resident (inbound investment). The key concept applicable to this type of income is whether the income of the non-resident is sourced in the jurisdiction that wants to tax it.

Cross-border taxation can be distinguished from purely domestic taxation (i.e. a sovereign government taxing its residents on business carried out within its own jurisdiction).
There has been enormous growth in international transactions due to the liberalisation of trade, the abolition of currency controls and, more recently, technological advancement. Academic studies indicate that in 2007, the year before the Great Financial Crisis, world trade was about two times greater than in 1997, six times greater than in 1972 and thirty-two times greater than in 1950. These same studies suggest that global exports are more than 4,000 times larger than in 1913.\(^1\)

Over the decades this has led to a dramatic increase in the flow of capital investments among countries so that national economies have become interconnected. The features of globalisation include the free movement of capital and labour, developments in technology and telecommunications, the growth of the service component in the economy, the increased importance of intellectual property, and the use of integrated supply chains. These features have enabled businesses, through sophisticated transfer pricing techniques (involving, for example, the pricing of goods and services, location of indebtedness and intellectual property), fragmentation of business activity and the ability to transact without a physical presence in a jurisdiction, to locate productive activities, risks and, most importantly, profits to jurisdictions with little or no taxation.

1.1.2 Income Tax and Cross-Border Trade: A Relatively Recent Phenomenon

While it is reasonable to surmise that cross-border trade significantly predates direct (income) taxation, there has likely always been some link between international trade and some form of taxation. Originally this taxation may have simply taken the form of a rudimentary toll or levy (for example, a payment made to allow a ship to pass a chain blockading passage along a river). More sophisticated means of taxation such as income tax (late eighteenth century in a country such as the United Kingdom to fund the Napoleonic wars) are associated with the development of nation-states emerging, after the Peace of Westphalia in 1648, from the religious wars.\(^2\) Although the Silk Roads (the ancient trade route

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network of the Chang’an–Tianshan corridor) are much older than income tax, it is conventional to view cross-border taxation as simply a nineteenth- and twentieth-century phenomenon. Due to the comparatively recent nature of cross-border taxation, it may be helpful to see whether the past can help to provide any potential solutions to some of the issues described in this book. In that sense, it may be possible to regard the partial move to destination taxation as a step consistent with older historical concepts of taxation where taxes were imposed when goods were brought to the market or physically transferred from one jurisdiction to another.\(^3\)

### 1.2 Fundamental Concepts of International Taxation: Residence and Source

The majority of countries tax both consumption and income.\(^4\) The taxation of consumption occurs when a transaction results in the exchange of goods and services for consideration. This will often be to a final end-user (value-added taxes, goods and services taxes and retail sales taxes), but it might also occur on transactions between businesses before the final sale. Excise taxes and import duties are levied on particular goods or services. The common feature is that consumption taxes are normally levied where the consumer is located, which is the importing country (described as the place of destination).\(^5\)

The taxation of income normally takes place in respect of net income earned over a period of time and is usually on an annual basis. The right of an international jurisdiction to taxation is said to be founded either on the relationship to a person (described in the OECD Commentary as the taxpayers’ personal attachment to the state)\(^6\) or on the relationship to a territory.\(^7\)

\(^3\) See Section 9.3.1 “A Move to Destination Taxation”.  
\(^5\) The destination principle is also an important possibility for income tax reform. This is discussed in further detail at Chapter 8, as the principle is utilised in many of the alternative policy strategies which have influenced the 2020s compromise.  
\(^7\) W Schon “Persons and Territories: on the International Allocation of Taxing Rights” (2010) 6 BTR 554 at 554. In this article, Schon successfully sets out to show the fragility of the concepts of personal and territorial attachment which purportedly underpin the power to tax.
1.2.1 Residence Taxation

When considering the relationship between a right to tax and the taxpayer’s personal attachment to the state, the question of where the taxpayer’s residence is located (for tax purposes) is the critical issue in most jurisdictions.

It seems clear that international law accepts that a state may levy taxes against a taxpayer not within the territory of the state, so long as there is a real link between the state and the taxpayer, such as nationality or domicile. So it is even clearer that a state can levy taxes for a taxpayer resident in its own jurisdiction even when the profits it wishes to tax are earned abroad.

With respect to cross-border business income, residence-based taxation applies to outbound investment, as discussed above.

If a country operates a worldwide tax system, it subjects the residents of that country to tax in respect of income sourced both in and outside their country. In contrast, if the country operates a territorial system then it subjects its residents to tax only on income derived from sources in its own jurisdiction. Particularly when dealing with corporate income tax most countries operate hybrid systems adopting features from both the worldwide and territorial regimes. The OECD points to the difficulty for the tax administration in collecting information with respect to the foreign-sourced income of their residents as the reason why these hybrid systems proliferate.

1.2.2 Source Taxation

Source taxation is imposed because of the connection between the territory in which the income is earned and the taxpayer.

Concerning inbound investment (a state imposing tax on non-residents doing business in their jurisdiction), tax is imposed on income sourced in their jurisdiction. Determining whether income is sourced in a jurisdiction is usually a matter of domestic law for the jurisdiction concerned. Accordingly, the source rules vary from country to country but they follow a broad pattern. While active business income

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8 See Shaw, above n 2 at 486.
9 OECD, above n 4 at 23.
10 See Section 1.1.1 “Introduction”.
11 See Section 1.7 “Exploring the Limits of Domestic Source-Based Taxation”.

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is normally taxed on a net income basis at the marginal tax rate of the non-resident taxpayer, other forms of passive income such as interest, royalties and dividends are taxed on a gross basis. The OECD suggests that this is due to the difficulty in establishing the expenses a non-resident incurred in earning such passive income.\textsuperscript{12} As this source-based taxation takes place on the gross income, the tax rate is normally low.

1.2.3 The International Tax Dilemma Arising from the Competing Demands of Residence and Source Taxation

In theory, countries could operate exclusively on residence-based taxation or source-based taxation. The problem with operating on a worldwide residence-based system is that for it to be effective you need all the other countries to be doing the same. That is, there is an agreement that all countries in the world would tax their residents on worldwide income and no country would tax non-residents on income sourced in their jurisdiction.

Operating a territorial source-based system does not require the same degree of international cooperation and, historically, many countries did just that and operated their tax systems based on income earned in their own jurisdiction. It is now rare to find examples,\textsuperscript{13} and given the global mobility of capital it would be hard for many of us to contemplate such a regime whereby residents diverted all their capital overseas and escaped local tax.

In an increasingly global economy, countries will have both exports and imports (with the resultant offset of the two being the balance of payments) and they will also operate a capital account which reflects the net change in ownership of national assets (in other words, it records the change in foreign ownership of domestic assets together with the change in domestic ownership of foreign assets).

Source taxation is generally unpopular among economists writing on international taxation.\textsuperscript{14} They acknowledge that it is consistent with capital import neutrality (CIN), which is the principle requiring all

\textsuperscript{12} OECD, above n 4 at 24.
\textsuperscript{13} The taxation of business profits in Hong Kong is one such example. Profits Tax is only charged on profits which arise in or are derived from Hong Kong. In simple terms this means that a person who carries on a business in Hong Kong but derives profits from another place is not required to pay tax in Hong Kong on those profits.
investors to pay the same marginal tax rate notwithstanding whether they are residents or non-residents. Under CIN, all savers (regardless of where they are resident) face the same after-tax returns resulting in the efficient allocation of savings. These economists say that taxes on investment in the home jurisdiction lead to a reduction in investment because investors will seek the highest after-tax return and that the home jurisdiction, through high taxation, diverts investments away from itself to other, more tax-friendly jurisdictions. This can distort investment and production and they believe the incidence of the tax falls on domestic labour and other fixed factors. They acknowledge, however, that developed countries typically employ source taxation.

On the other hand, residence-based taxation adheres to the principle of capital export neutrality (CEN) because an investor is neutral about whether they invest domestically or overseas. This is because both provide the same marginal rate of income tax regardless of where capital is invested. Economists generally like CEN because of its apparent worldwide economic efficiency, recognising that the location of investments is unaffected by taxation.

Michael Graetz argues that despite the repeated reference to the CEN and CIN principles by international tax policymakers it is impossible to achieve the outcome of simultaneous adherence to them unless we have a worldwide government or identical income tax bases and rates in all nations. Graetz supports this by highlighting an “irreconcilable conflict” between three simple principles:

1 People should pay equal taxes on their income regardless of the country that is the source of that income.
2 All investments in a country should face the same tax burden regardless of whether a foreigner or a local made their investment.
3 Sovereign countries should be free to set their own tax rates and vary them.

He then points out that the first two principles can only hold simultaneously when capital income is taxed at the same rate in all countries, requiring identical tax systems, not just rates but also tax bases and

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16 Kaplow, above n 14 at 689.
17 Ibid at 689.
18 Graetz, above n 15 at 272.
sourcing rules. This can never happen unless the third principle is breached.

It is said that capital-exporting and capital-importing nations have “conflicting financial interests: capital importers have the most to gain from taxation at source, capital exporters from the taxation of residents.”\(^{19}\) Another way to look at this is the way Louis Kaplow summarises it: “that a large net capital importer will wish to tax the inflow and a large net exporter benefits by taxing the outflow”.\(^{20}\) Developed countries tend to be net capital exporters, developing countries net capital importers. From these generalities, one can see that there is a geopolitical dimension to international tax as well as the theoretical economic and legal construct.

When countries decide that they will continue to operate on worldwide residence-based taxation and to tax non-residents on income sourced in their jurisdiction then double taxation must arise. A resident of one country earning income in another jurisdiction will be legitimately subject to tax twice: first by the source jurisdiction where the income is earned, and secondly by the country in which they are resident.

This international tax dilemma led to the system of international taxation that we currently have. How have the competing demands of capital-importing and capital-exporting countries been dealt with in terms of the framework that we currently have in our international tax regimes?

1.3 The History of International Double Taxation: The “1920s Compromise”

This part of the chapter deals with a brief history of international double taxation and describes the formation of the “1920s compromise”.\(^{21}\) This was a problem arising out of industrialisation and was due to the implementation of income tax regimes around the world and increasing

\(^{20}\) Kaplow, above n 14 at 689.
\(^{21}\) This is the terminology employed by Michael Graetz and Michael O’Hear in their outstanding article on the history of the US tax policy and in particular the impact of Thomas Adams, a professor of economics at Yale and tax advisor to the Treasury Department and Treasury’s principal advisor on issues of tax policy and administration. See Graetz and O’Hear, above n 19 at 1026.
cross-border trade. Commentators trace the current international tax regime to the model originally developed as a result of the unification of Germany and applied in double tax treaties entered into by the predecessor states of the German Empire. The first international double tax agreement was concluded on 21 June 1899 between the Kingdom of Prussia and the Austro-Hungarian Empire and it dealt with the double tax issue in a way that is very familiar to us all, by allocating taxing rights to the state of domicile (which of course we now think of as residence) concerning personal taxes, and the state of source in relation to business and property taxes.

In the years following the First World War the world was increasingly moving from a territorial system to a worldwide residence system and at the same time increasing rates of tax. This was necessary because of the enormous expenditure incurred by many economies around the globe. The resultant combination of juridical double tax and high tax rates led the International Chamber of Commerce conference held in Brussels in 1920 to initiate a request to the League of Nations to address the problem of double taxation. In turn, the Financial Committee of the League of Nations asked four economists to consider the economic consequences of double taxation (from the perspective of the equitable distribution of burdens and interfering with the free flow of capital), to propose any general principles to remove the “evil consequences of double taxation” and to ascertain whether such principles were capable of application to a new international convention.

These four economists were not randomly chosen but were somewhat representative of the post-war economies. Two were from capital-importing (source-taxation-favouring) countries, Professor Bruins from the Netherlands and Professor Einaudi from Italy. Sir Josiah Stamp was from the United Kingdom, which was historically a major capital-

24 Jogarajan, above n 22 at 679.
exporting country (residence-taxation-favouring) and Professor Seligman was from the United States (a country that had been capital importing but was now the largest exporter of capital). These economists met and thrashed out a way forward and delivered a report in April 1923 (the 1923 Report) which has been seen by some as the foundation stone of the international tax regime. Others suggest that the 1923 Report, whilst influential, was not quite as fundamental as many people think it was.

Two key observations emerge from an examination of the original reports of the League of Nations.

1.3.1 Observation One: The Recommendation Was to Allocate Taxing Rights for Different Categories of Income between Residence and Source Countries

The 1923 Report proposed that an ideal solution would be that the individual’s “whole faculty” (the taxpayer’s capacity or ability to pay) should be taxed, but only once, and that the “liability should be divided among the tax districts according to his relative interests in each.” This division of taxation should occur after ascertaining where the “true economic interests of the individual are found”. This required an analysis of the “economic allegiance” that exists between the taxpayer and the state and involved an evaluation of four factors: (i) the production of wealth (also described as the origin of the wealth or acquisition); (ii) the position of wealth (also described as the situs and location of the wealth);

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27 Ibid. See also Hugh Ault “Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practice” 47 Tax L Rev 565 at 567.
28 Graetz and O’Hear, above n 19 at 1078. They suggest that while the 1923 Report in its organisational structure and rejection of source-based taxation of interest and dividends represents the basic blueprint of modern tax treaties, the really important concepts could be found in the existence of the recognition of the validity of source-based taxation and the importance of the foreign tax credit found in US legislation in 1919 and 1921 and the work of the International Chamber of Commerce (i.e. the work of Thomas Adams).
29 Bruins, Einaudi, Seligman and Stamp, above n 25; League of Nations (Technical Experts from Belgium, Czechoslovakia, France, Great Britain, Italy, the Netherlands and Switzerland) Double Taxation and Tax Evasion (F 212, Geneva, February 1925); League of Nations (Technical Experts from Argentina, Belgium, Czechoslovakia, France, Germany, Great Britain, Italy, Japan, the Netherlands, Poland, Switzerland, USA, Venezuela) Double Taxation and Tax Evasion (C. 216. M. 85, Geneva, April 1927); League of Nations (General Meeting of Government Experts) Double Taxation and Tax Evasion (C. 562. M. 178. Geneva, October 1928).
30 Bruins, Einaudi, Seligman and Stamp, above n 25.
(iii) the enforcement of the rights to wealth (legally enforceable rights); and (iv) the disposition of wealth (the consumption or sale in a market).\textsuperscript{31}

Even after carefully working through these four “fundamental considerations”\textsuperscript{32} and trying to apply the various contributions made by different states to the production and enjoyment of income, the economists concluded “that it is almost impossible in economic theory to get a direct assignment of a quantitative character of finally resultant income amongst all the national agents who may be said to have had a finger in the pie”.\textsuperscript{33} Given this theoretical difficulty, they concluded that in practice it was going to be necessary to have “a compromise or arbitrary assignment” of taxing rights.\textsuperscript{34}

In essence, the 1923 Report concluded that there were four alternatives to prevent/reduce double taxation:\textsuperscript{35}

1. the use of the credit method, whereby the residence state would give a foreign tax credit for any tax paid in the source state;
2. the use of the exemption method, whereby the source state exempted all non-residents from tax on income within their jurisdiction;
3. a proportional tax (so that a portion of the tax is paid in both the source and the resident state);
4. an allocation method, whereby certain categories of income would be subject to source state taxation (such as rents of land) whilst others would not be subject to source taxation (such as interest). The country of residence would allow a foreign tax credit where the country of source had required the payment of tax, but in circumstances where the country of source exempted it, they would get a full amount of taxation.

The four economists suggested a split between land, business enterprises directly dependent upon the land (like mines and oil wells), industrial establishments consisting chiefly of factories and commercial establishments with a fixed location, and that these should all be subject to tax in the source country. In contrast, income arising from shares (dividends)

\textsuperscript{31} Ibid at 20–4.
\textsuperscript{32} Ibid at 22.
\textsuperscript{33} Ibid at 45.
\textsuperscript{34} Ibid.
\textsuperscript{35} Ibid at 41–2.