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 the UK, this has been the case for centuries.[1] In practice, tax law 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 specific issue. Change to a tax law almost inevitably involves winners and losers, and thus all tax reform is controversial.[2] Added to this, the most important modern taxes are broad-based and touch nearly every dealing and 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, and 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 such a 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 EU, 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 onion. Care must be taken in

[1] See Harris (2006, 58), referring to the length of English direct tax laws dating to the sixteenth century.
[2] Hence the adage 'an old tax is a good tax'.

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 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 addition, EU Law is critically important in resolving international tax issues within the EU.[4] The influence of this body of law has been recognised outside the EU because the EU provides an advanced version of the issues faced by reason of globalisation. EU Law applicable to direct taxation is 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. A further purpose of this book is to analyse the limitations inherent in the OECD Model and to 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

[3] OECD (1992–).

[4] EU Law is that based on or under the Treaty on European Union and the Treaty on the Functioning of the European Union (the 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.

divergence simultaneously gives rise to potential double taxation as well as international 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 the domestic tax law of a number of influential countries. Domestic tax law can be both statutory (legislative) and case law based. This book is particularly written from the perspective of common law countries. As Avery Jones notes, with respect to international tax matters, common law courts often refer to courts in other common law countries – that 'is quite normal'. In addition, common law courts increasingly refer to decisions from civil law countries.[5] With these points in mind, when domestic tax law is relevant, reference in this book is made to statutes and court decisions of a number of common law jurisdictions, including Australia, Canada, India, New Zealand, South Africa, the UK and the US. There is no attempt to be comprehensive; which country is referred to depends on which is considered the most illustrative. EU tax law is usually self-standing, but to the extent that domestic tax law is relevant, German tax law is most commonly referred to.

As will be seen from the above, there are various limitations inherent in the scope of this book. First, it is limited to a consideration of income tax.[6] 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.[7] 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 UN Model or the US, are not referred to unless they provide a unique illustration of

[5] Avery Jones (2018, [3.5.2]).

[6] Some countries, such as the UK, limit a reference to 'income tax' to the taxation of income of individuals or entities other than corporations, with 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.

[7] For example, regarding the OECD Model, the International Bureau of Fiscal Documentation's *Global Tax Treaties Commentaries* (Vann, R (2014–) (ed.)) is particularly important. Copious reference is made to the contributions to this publication throughout this book.

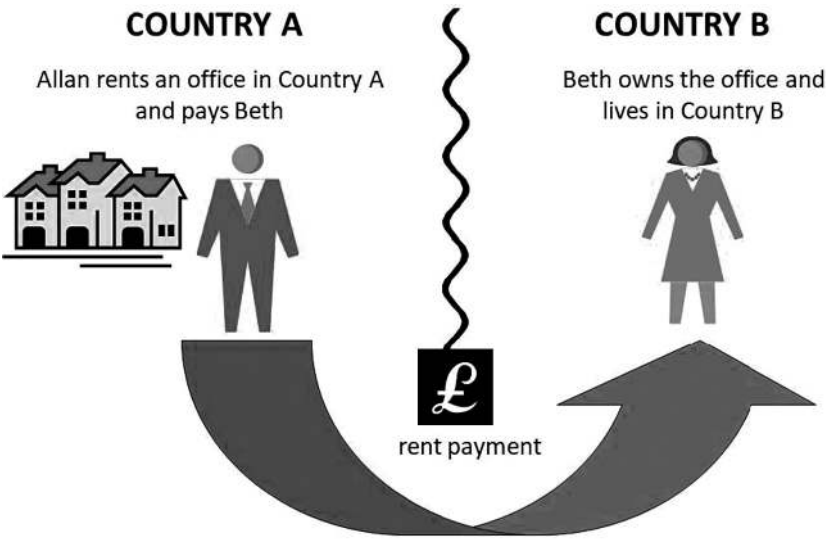
a particular point.[8] In all these matters, the focus is on illustrating and analysing how international tax law works in practice while providing sufficient references to facilitate more detailed research into particular issues.

The book is composed of seven chapters. It begins by setting the scene with a consideration of some important preliminary matters. Chapter 1 discusses relevant fundamentals of income tax. It does not discuss all 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 various important sources of international tax law. The chapter proceeds to identify the relevant sources and consider how they interrelate. The sources are quite different in their nature and form. The approach to interpretation of them may be different 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. There is a particular consideration of the source of anti-avoidance rules that are relevant in an international setting.

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 and inter-nation equity. 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

[8] Regarding the UN Model, see United Nations (2017a). Regarding the US Model, see United States (2016). The International Tax Centre at Leiden produces useful resources that contain 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 Court of Justice of the European Union; see https://webshop.itc-leiden.nl/, accessed 18 December 2019.



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, at the least, international tax 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 country) is considered in Chapter 3, and the tax system of Country B (the residence country) 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 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 the 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 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 country. 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, thin capitalisation and reconciliation, where income may be characterised in different ways.

Chapter 4 switches to the residence or home country of the income recipient (i.e., Country B). It presumes taxation of the recipient (Beth) by the source country (Country A) in accordance with the rules and considerations outlined in Chapter 3. It begins by looking at the likely response of the residence country under its tax law to taxation by the source country (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. The chapter then turns to consider problems that arise where the income is derived through a corporation in the source country. These include the risk of economic double taxation and methods to relieve it, as well as potential deferral or avoidance of residence country (Country B) taxation and the use of controlled foreign corporation rules to prevent these.

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. The discussion then 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 situation. 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 setting. Chapters 3 and 4 consider the rules that do

exist. By contrast, Chapter 5 focuses on the limited scope of tax treaties – that is, issues treaties don't cover or at least don't cover well. 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. However, in this increasingly integrated world, the potential is that a given cross-border dealing is not simply bilateral but rather involves 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 various 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. Particularly, 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 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 through 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 various 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 tax administrations 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 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.

1

Fundamentals and Sources of International Tax Law

The purpose of this chapter is to outline background material that is important in later discussion. 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 various income tax fundamentals that are important when projected into an international setting. The second heading proceeds to identify the sources of law that are referred to and analysed in the remainder of this book. The focus is primarily on three sources of law: domestic tax law, tax treaties and EU Law, although residually some 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 approaches to interpretation of the sources by relevant courts. Here the focus is on the approach to interpreting tax treaties, which may be different from that used when interpreting domestic law. Also of importance is the jurisprudence of the Court of Justice of the EU ('CJEU'), the central court appointed to interpret EU Law.

1.1 Tax Fundamentals[1]

What Are Taxes and What Are the Different Types?

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

[1] For a more detailed consideration of tax and particularly income tax fundamentals, see Harris (1996, 1–37) and Harris (2017a, [1.1]).

government.[2] At some level, if there were no taxes there would be no government. In the words of the famous American judge Oliver Wendell Holmes, '[t]axes are what we pay for civilized society'.[3] 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, numerous times in the FEU Treaty.[4] 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 paying a road toll 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 OK). A UK example of a charge for services is the television licence fee, which, while paid into the consolidated fund, is used to fund the British Broadcasting Corporation (BBC).[5]

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.[6] The fact that tax is payable in money (local currency) causes problems that impact 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

[2] And see Wei Cui (2018, [2.1]).
[3] *Compania de Tabacos* v. *Collector of Internal Revenue* (1927) 275 US 87 (SC) at 100.
[4] The word 'tax' is used in the FEU Treaty in Art. 65(1), which is one of the provisions dealing with acceptable limitations on the free movement of capital, and Part III, Title VII, Chapter 2 (Arts. 110–13), which deals with tax provisions.
[5] For an example of a licence fee held to be a tax and therefore invalid without the 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 Loutzenhiser (2016, [1.1.2]) and Shanske (2017, 1).
[6] 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 16, 84, 144 and 478.