International Tax Primer

FIFTH EDITION

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Preface

The first edition of the *International Tax Primer* began in the 1990s as a project to develop materials for the Organisation for Economic Co-operation and Development (OECD) for use in its outreach activities with emerging economies in Europe after the breakup of the Soviet Union. I recruited Mike McIntyre of Wayne State University to work with me in preparing those materials. Unfortunately, the materials we prepared proved to be unacceptable to the OECD largely because, in our view, at least, they did not adhere sufficiently to the OECD positions on several international tax issues. However, the OECD generously permitted us to use the materials as the foundation for what became the *International Tax Primer*.

Much to my surprise and delight, the first four editions of the Primer were well received by students of international tax from all over the world. I hope that a new generation of students will find this fifth edition to be helpful in the increasingly challenging task of understanding international tax.

Mike McIntyre, my co-author on the first two editions, passed away in 2013 after a long illness. Mike's insight and knowledge about international tax can still be seen in the subsequent editions of the Primer.

The fifth edition of the *International Tax Primer* has been revised and expanded substantially to deal with the developments in international tax that have occurred since 2018, especially the OECD Inclusive Framework's proposed two-pillar approach for dealing with the problems for the international tax system posed by the digitalization of the economy. Shortly after the publication of the fourth edition in 2018, the Inclusive Framework began its work on the two pillars on a priority basis. Quite naturally, I thought that a new edition of the Primer would be necessary and appropriate once the details of the two-pillar proposals became available, and it was relatively certain that the proposals would be implemented. Detailed Blueprints for Pillar One and Pillar Two were issued in October 2020 but were not well received, and the entire project appeared to be in jeopardy. As a result, I put my plans for a new edition on hold. However, over the course of 2022, after the two-pillar proposals were revised and later endorsed by the European Union, the G20 and the United States, I decided that it was appropriate to proceed with a fifth edition.

progression). In some countries, certain types of foreign source income (typically business income) may be exempt, while other types are subject to residence country tax. As a result, as noted above, just because a country is described as taxing on a worldwide basis does not mean that it taxes all foreign source income derived by residents.

Example

Ms. X is a resident of Country X. She has income from employment in Country X of 100,000. She also receives dividends of 10,000 from corporations resident in Country Y and interest of 3,000 from a bank account in Country Z. The dividends are subject to withholding tax in Country Y of 15%, or 1,500, and the interest is subject to withholding tax in Country Z of 10%, or 300. Ms. X's income and tax payable to Country X might look as follows:

Income from Country X	100,000
Foreign source income:	
Dividends from Country Y	10,000
Interest from Country Z	3,000
Worldwide income	113,000
Less: personal allowance	10,000
Taxable income	103,000
Tax payable (40%)	41,200
Less: single parent credit	1,200
Foreign tax credit	1,800
Net tax payable	38,200

3.2.3 Double Taxation

If one country taxes its residents on their worldwide income and another country taxes part of that income because it is derived from sources in that country, the income is subject to double tax. Worldwide taxation of residents inevitably results in double tax because most countries insist on taxing income that is derived or has its source in their countries. The well-established international norm is that the source country—the country in which the income arises, is derived, or has its source (all these terms are commonly used to describe a source country)—has the first right to tax the income and the residence country has a secondary right to tax the income; however, if the residence country does so, it must provide relief for the source country's tax in order to eliminate double taxation. The methods that residence countries use to eliminate double taxation of foreign source income earned by their residents are discussed in Chapter 4.

3.2.4 Computation of the Foreign Source Income of Residents

3.2.4.1 *In General*

Since residents are taxable on their worldwide income, rules are necessary to compute both their domestic source income and foreign source income. Typically, the same rules apply for the purpose of computing both types of income. The same amounts are included in income, the same deductions are allowed, and the same timing rules apply. However, tax incentives may be restricted to domestic source income. For example, a country may provide accelerated depreciation for investment in machinery and equipment used in certain domestic industries or areas of the country, or it may provide enhanced write-offs for domestic research and development activities carried out in the country.

Source rules are irrelevant for purposes of determining the worldwide income of residents since all income, domestic and foreign, is included in computing their income and is taxable. However, source rules are required if any items of foreign source income (e.g., income attributable to a foreign branch or PE) are exempt from tax. In addition, source rules are necessary for purposes of determining the limitation on the foreign tax credit. As discussed in detail in Chapter 4, a country that taxes the foreign source income of its residents is obligated by its treaties (and also by considerations of international practice and fairness) to allow a credit against its domestic tax for the foreign tax paid on the foreign source income. However, this credit for foreign taxes is typically limited to the amount of domestic tax on foreign source income.

Expenses incurred to earn foreign source income are usually deductible if the foreign source income is subject to tax. Sometimes there may be a serious mismatch between the timing of the recognition of the income and the timing of the deduction of expenses. For example, a taxpayer may borrow funds to finance the earning of foreign source income. The interest will be deductible currently but with respect to some items of income, such as dividends, the inclusion of the income may be postponed to subsequent years when the income is received. The same type of timing mismatch often occurs with respect to research and development expenses.

If foreign source income is exempt from residence country tax, in principle, any expenses incurred to earn such income should not be deductible. Many countries, however, allow the deduction of interest expense on borrowed funds used to acquire shares of foreign corporations even where dividends received from such corporations are exempt from residence country tax. This issue has become increasingly important as more countries have adopted participation exemptions for dividends from foreign corporations. The OECD's BEPS Action 4 Final Report: *Interest Deductions and Other Financial Payments* deals with this issue and is discussed in more detail in Chapter 7, section 7.2. Although expenses incurred to earn foreign source income that is subject to residence country tax are deductible in computing a taxpayer's worldwide income, these expenses should also be deducted in computing foreign source income for purposes of the limitation on the foreign tax credit. This issue is discussed further in Chapter 4, section 4.4.

3.2.4.2 *Foreign Exchange Gains and Losses*

Foreign source income is often earned in the currency of the foreign country in which it is earned. Similarly, expenses incurred to earn foreign source income are often incurred in foreign currency. In a worldwide tax system, a resident's income must generally be reported in the currency of the country of residence. As a result, amounts of revenue and expense expressed in foreign currency must be translated into the domestic currency, and gains and losses from movements in foreign currency may be realized. In theory, each revenue and expense item should be translated at the exchange rate applicable at the time that the amount is earned or incurred. For practical reasons, some countries allow amounts denominated in foreign currency to be translated into domestic currency using average exchange rates (monthly, quarterly, or annually). Foreign currency gains and losses are discussed further in section 3.4.4 below.

3.2.4.3 *The Treatment of Losses*

Under a worldwide tax system, residents are taxable on their foreign source income. It follows that, in principle, they should be allowed to deduct any losses from foreign sources. Although this treatment of losses is consistent with the treatment of foreign source income from a theoretical perspective, it gives rise to problems since taxpayers can manipulate the deductibility of business losses inappropriately. For example, a taxpayer may commence business operations in a foreign country through a branch rather than a foreign subsidiary so that the start-up losses are deductible against the taxpayer's worldwide income in its country of residence. Once the business becomes profitable, the taxpayer can transfer the assets of the business to a foreign subsidiary—often on a tax-free basis—so that future profits derived by the foreign subsidiary are not subject to tax by the taxpayer's country of residence, as explained in section 3.3.1 below.

If the residence country exempts some foreign source business income (e.g., business profits attributable to a foreign PE), then any foreign source losses attributable to a foreign PE should not be deductible in computing the taxpayer's worldwide income.

Some countries try to protect their tax base against the inappropriate deduction of foreign losses. Various rules are used for this purpose. For example:

- deductions of foreign source losses may be limited to a taxpayer's foreign source profits; and
- deductions for foreign source losses may be recouped if the foreign business is sold or transferred to a foreign subsidiary.

3.2.5 Tax Administration Issues

Taxing the foreign source income of residents presents special problems of administration and enforcement for the tax authorities of the residence country. The tax authorities require information concerning the taxpayer's foreign source income, both to ensure that all the income is reported and to verify that the income is properly computed. Typically, in the first instance, the tax authorities will attempt to obtain this information from the taxpayer. Taxpayers may also be required to provide information about their foreign income-earning activities on a regular basis in their tax returns, through information-reporting returns, or pursuant to a specific request from the tax authorities. The tax authorities of the residence country may also obtain information from the tax authorities of the country where the income is earned under the exchange-of-information article of the tax treaty between the two countries or the Multilateral Convention on Mutual Assistance. Exchange of information under tax treaties is discussed in Chapter 8, section 8.8.4.

Not surprisingly, taxpayers are sometimes tempted not to provide full disclosure to the tax authorities concerning their foreign source income because it is much more difficult for the tax authorities to obtain information that is located outside the country than to obtain domestic information. Taxpayers may also be tempted to provide only favorable information. As a result, some countries have adopted rules to discourage this practice. Under these rules, if a taxpayer does not make full disclosure, the taxpayer is precluded from introducing any further information in any subsequent legal proceedings involving the foreign source income.

The tax authorities of one country are not generally allowed to visit another country for the purpose of auditing a taxpayer's reported foreign source income unless invited to do so by both the taxpayer and the foreign government, making it more difficult for the tax authorities to verify information provided by a taxpayer concerning its foreign activities. Some countries have addressed this issue by entering into arrangements providing for joint audits in certain circumstances.

3.3 EXCEPTIONS TO WORLDWIDE TAXATION

3.3.1 Nonresident Companies and Other Legal Entities

Although countries are said to tax on a worldwide basis, the reality is quite different. In theory, if a resident of a country that taxes on a worldwide basis earns income from another country, that foreign source income will be subject to residence country tax. If, however, the resident establishes a foreign corporation or other foreign entity to earn foreign source income, that income will not be subject to tax by the residence country in the absence of special rules such as CFC rules or **Foreign Investment Fund (FIF) rules**. The foreign entity is generally considered to be a separate taxable entity from the resident who owns it, and, in most cases, the foreign entity will be considered to be a nonresident of the country in which the resident shareholder or owner resides. As a result, it is relatively easy, especially for corporations resident in a particular country,

to avoid paying tax to that country on foreign source income through the use of foreign corporations or other legal entities such as trusts.

Example

Corporation A, resident in Country A, derives income of 1 million from business activities in Country B. The tax rate in Country B (20%) is lower than the rate in Country A (30%). As a result, assuming that Corporation A has a PE in Country B, it will pay tax to Country B of 200,000 on the income of 1 million derived from Country B. Assuming that Country A taxes on a worldwide basis, Corporation A will also pay Country A tax of 100,000 on the income of 1 million earned in Country B (300,000 less a credit for 200,000 of Country B tax). If Corporation A establishes a wholly owned subsidiary corporation in Country B and that subsidiary earns the income of 1 million from Country B that would have been earned directly by Corporation A, the subsidiary will pay 200,000 of Country B tax; however, Corporation A will pay no additional tax to Country B or Country A until it receives dividends from the subsidiary or sells its shares of the subsidiary.

Where Country A exempts dividends from foreign corporations in which companies resident in Country A have a substantial interest (as many countries do), Corporation A can completely avoid Country A's tax on the income shifted to Country B. Even where Country A taxes dividends from foreign corporations, that tax is deferred until such dividends are received, which, in the case of foreign subsidiaries, is within the control of the resident parent corporation.

The immediate tax saving by Corporation A of 100,000 is easy and inexpensive to achieve; it simply requires the incorporation of a foreign corporation and the transfer of the income-earning assets to it. As a result, it is not surprising that the use of CFCs and other foreign entities, such as trusts, as tax-planning devices, is widespread. Nor is it surprising that several countries have responded to such planning with rules to prevent the avoidance or deferral of domestic tax by the use of such foreign entities. These rules are discussed in Chapter 7, sections 7.3 and 7.4.

3.3.2 Temporary Residents

Some countries have special rules for temporary residents to relieve them of some of the more onerous aspects of residence taxation. Temporary residents are persons, such as corporate executives, who may be clearly resident in a country because their homes, families, and employment are located in the country but who intend to be, and are, resident only for a limited period of time, usually less than five years. As residents of the country, they become subject to all of that country's rules concerning the taxation of foreign source income, but because they are only temporarily absent from their home countries, these temporary residents often retain substantial economic interests there. The application of the full range of residence country rules to temporary residents can cause serious problems that may discourage talented persons from taking short-term postings in other countries.

Two specific examples may serve to illustrate the difficulties. Assume that an executive resident in Country A is a member of the company's pension plan. Under the tax law of Country A, the executive is entitled to deduct contributions to the plan and is not taxable on the employer's contributions to the plan. Moreover, the income earned and accumulated in the plan is not taxable. However, distributions from the plan are taxable in full. Assume further that the executive takes a temporary posting in Country B, which does not allow any deduction for the executive's contributions to the pension plan and taxes the executive on the employer's contributions to the plan as a fringe benefit from employment. Country B taxes distributions from the pension plan only to the extent that they exceed the employee's and employer's contributions to the plan. The executive plans to retire in Country A. To the extent of the contributions to the plan, while the executive is resident in Country B, the executive will be subject to double taxation: once in Country B because Country B will impose tax on the executive with respect to the employer's contributions to the plan and will not allow any deduction for the executive's own contributions, and again in Country A when the executive receives distributions from the plan. This double taxation is clearly unfair and should be eliminated.

As a second example, assume that A, a resident of Country A, establishes a trust under the laws of Country A for the benefit of his or her children. Country A taxes the income accumulating in the trust but at the tax rates applicable to the children. A moves to Country B to take a temporary position for a few years and becomes subject to special rules in Country B for residents who have established foreign trusts. Most likely, A did not establish the trust to avoid Country B tax because, at the time the trust was established, A might not have known about the future move to Country B. Under Country B's rules, A is taxable on the income of the foreign trust even though the trust is taxable on its income in Country A. To eliminate this double taxation, some countries exempt temporary residents from their foreign trust and FIF rules for a limited period of time.

3.4 SPECIAL ISSUES

3.4.1 Exit or Departure Taxes

When a person ceases to be resident in a country that taxes residents on their worldwide income, the person will no longer be subject to tax on worldwide income in that country. However, the consequences of ceasing to be resident are not quite so simple. For example, what if the person owns shares of a resident corporation that are worth significantly more than when they were acquired? Under most tax treaties, capital gains derived by a taxpayer resident in one country from the disposal of shares of a company resident in the other country are taxable only by the country in which the taxpayer is resident (unless the value of the shares is attributable primarily to immovable property located in the country). Therefore, if the person moves to another country that has a treaty with his or her former country of residence, the shares can be sold without any tax imposed by the former residence country. If the new country of

residence has been chosen carefully, it may impose no tax, or little tax, on the gain realized on the sale of the shares. Not surprisingly, the former country of residence is unlikely to find this result acceptable.

Several countries have adopted special rules, often called exit or departure taxes, to prevent the avoidance of domestic tax by departing residents. Countries that have adopted exit taxes applicable to all property include Australia, Canada, and Norway. Other countries, such as France, Germany, and the Netherlands, have more limited exit taxes that apply only to certain shares in resident companies. The U.S. has an even more limited exit tax that applies only to transfers of tangible property out of the U.S. by U.S. citizens who give up U.S. citizenship and U.S. permanent residents (green card holders) who give up that status.

Typically, these taxes operate by requiring the departing resident to pay tax not only on the income and gains realized up to the date that the taxpayer ceases to be resident but also on any accrued but unrealized income or gains. For example, assume that X, a resident of Country X, ceases to be resident on September 30, 2022. At that time, X's worldwide income from January 1, 2022, to September 30, 2022, is 70,000. X also owns shares in a company that was established several years ago and which is now very successful. The shares currently have a value of 30 million. The cost of the shares to X is nominal. X also owns an interest-bearing bond issued by a company resident in Country X. The interest on the bond is payable annually on December 31. If Country X does not impose any tax on departing residents, X will not pay tax on the accrued gain on the shares or on the interest accrued to September 30 on the bond. When X sells the shares or receives the bond interest after September 30, 2022, X will no longer be resident in Country X. Even if Country X imposes tax on nonresidents deriving interest from Country X and realizing capital gains on shares in companies resident in Country X, there may be a tax treaty between Country X and X's new country of residence that prevents Country X from taxing.

As noted above, tax treaties based on the OECD or UN Model Treaties preclude a country from taxing residents of the other country on capital gains from disposals of shares of resident companies unless the assets of the companies consist primarily of immovable property located in the country. Treaties also typically limit the tax imposed by a country on interest paid to a resident of the other country to 10% or 15%, which may be significantly less than the rate of tax applicable to interest derived by residents.

To avoid these results, Country X may decide to impose an exit or departure tax on persons ceasing to be resident. Under these rules, X will be deemed to have disposed of the shares for their fair market value at the time of departure and to have received the interest accrued on the bond immediately before ceasing to be resident. These amounts would be included in X's worldwide income for the period ending on September 30, 2022, and would be subject to tax in Country X. The treaty with X's new country of residence would not apply to preclude Country X from taxing X on these amounts as long as Country X's tax is imposed on income derived or deemed to be derived at a time when X was still a resident of Country X.

Special problems are encountered with departure taxes. Most important, the taxpayer often may not have the funds to pay the tax because the income has not actually been received or the property has not actually been sold. Accordingly, some

countries allow the departing resident to defer the payment of the tax (with interest) if appropriate security for the ultimate payment of the tax is provided. A departure tax may also cause serious problems of double taxation. Most countries without departure taxes measure the amount of a gain on the disposal of property as the difference between the sale proceeds and the historical cost of the property. If a taxpayer ceases to be resident in a country that levies a departure tax, the taxpayer will be subject to tax on the accrued gain in respect of capital property owned at the time of departure. The accrued gain is the amount of the value of the property immediately before departure (e.g., 1,000) in excess of the historical cost of the property (e.g., 200), so the accrued gain is 800. When the taxpayer sells the property at a future date, the taxpayer's new country of residence will usually tax the entire gain (e.g., 1,800, computed as proceeds of sale (2,000) less historical cost (200)) and not just the portion of the gain (1,000) that was not taxed by the former country of residence. Thus, a portion of the gain (800 in this example) would be subject to double taxation. In this situation, under the provisions of a typical tax treaty, neither country is obligated to provide relief for the other country's tax because both countries impose tax on the basis of the taxpayer's residence (but for different years, so that the tie-breaker rules for dual residents do not apply).

Countries that impose departure taxes often deem taxpayers becoming resident to have acquired property owned at that time for its fair market value. In effect, the taxpayer is given a step-up in the cost of the property for tax purposes from its historical cost to its value at the time the taxpayer becomes resident. The overall result of this step-up in cost and the departure tax is that the country taxes only gains and losses accrued while a taxpayer is a resident of the country; gains and losses accruing before a taxpayer becomes resident or after a taxpayer ceases to be resident are not taxable by that country.

3.4.2 Trailing Taxes

Some countries have adopted a so-called trailing tax as an alternative or supplement to an exit tax. Under a trailing tax, a country imposes tax on all or certain items of income of a resident, even if the resident ceases to be a resident under the country's ordinary rules for determining residence. These trailing taxes take a wide variety of forms and may be broad or narrow in scope. For example, some countries, such as Germany, have special rules under which former residents who move to designated tax havens continue to be subject to tax on their entire income as deemed residents. The U.S. has a similar rule for U.S. citizens who give up their U.S. citizenship to avoid U.S. tax. Such former U.S. citizens continue to be subject to U.S. tax for ten years after they renounce their U.S. citizenship.

One common type of trailing tax applies to capital gains. As noted above in section 3.4.1, dealing with exit taxes, residents of high-tax countries may avoid tax on accrued capital gains by shifting their residence to a country that does not tax capital gains or taxes them at a low rate and then disposing of the property. An exit tax on departing residents captures only the gain accrued to the date that the taxpayer ceases

to be resident. Under a trailing tax, the taxpayer would be subject to tax on the entire gain if property owned at the time the taxpayer ceased to be resident is disposed of within a certain period after the taxpayer ceases to be a resident (typically five to ten years). The basic operation of a trailing tax on capital gains of former residents of a country and the relationship between a trailing tax and an exit tax are shown in the following example.

Example

Country A imposes tax on capital gains at a rate of 15%; however, Country A does not impose tax on capital gains from the disposition of shares of resident companies (other than gains from the disposition of shares that derive their value principally from immovable property located in Country A) realized by nonresidents. A, a resident of Country A, owns shares of a company resident in Country A that originally cost 1 million and now have a value of 10 million. If A moves from Country A to Country B, which does not tax capital gains, A can avoid Country A's capital gains tax on the 9 million accrued gain. In order to prevent this type of tax avoidance, Country A may adopt a trailing tax. This trailing tax would apply to any capital gains in respect of property owned by former residents at the time they cease to be resident if the property is disposed of within five years after they cease to be resident. Therefore, under the trailing tax, if A disposes of the shares for 13 million within five years of ceasing to be resident in Country A, the entire 12 million gain would be subject to tax by Country A.

If Country A has an exit tax, A's accrued capital gain of 9 million at the time that A ceases to be resident in Country A would be subject to Country A tax at that time. When A sells the shares for 13 million, say, four years later, an additional capital gain of 3 million (proceeds of 13 million less deemed cost of 10 million) would be subject to tax under Country A's trailing tax. However, if A waits for more than five years after ceasing to be resident in Country A to sell the shares, the trailing tax would not apply.

Any tax treaties that a country enters into will prevent the application of the country's trailing tax unless those treaties contain special provisions allowing the imposition of such a tax. Article 13 of the OECD and UN Model Treaties does not allow the imposition of trailing taxes on capital gains realized by former residents. Therefore, on the facts of the preceding example, if at the time of the sale of the shares, Country A and Country B have a tax treaty with an article dealing with capital gains that is similar to Article 13 of the OECD or UN Model Treaties, A would be entitled to the benefits of the treaty as a resident of Country B, and Country A would not be entitled to tax A's capital gain from the sale of the shares (unless the value of the shares was derived primarily from immovable property situated in Country A or the shares represent a substantial interest in the company (UN Model Treaty only)). Some countries put special provisions in their tax treaties to allow them to impose trailing taxes on certain capital gains.

Some countries, such as the U.K., impose tax on former residents who resume their residence within a relatively short period (five years in the case of the U.K.). The tax applies to capital gains realized during the time that the taxpayer was a nonresident but applies only on the resumption of U.K. residence.

3.4.3 Resident for Part of a Year

Special rules may be necessary if a taxpayer is a resident of a country for only part of a year. Some countries may impose tax on a taxpayer's worldwide income for the entire year if the taxpayer is resident at any time during the year. This result seems harsh, especially if the taxpayer's new country of residence follows the same practice, although the dual-residence tie-breaker rules in tax treaties may provide relief in some circumstances. As a result, some countries have rules to tax part-time residents on their worldwide income for only the portion of the year during which they are actually resident. These rules may be difficult to apply with respect to certain types of income, such as business income, that are usually calculated on an annual basis. A taxpayer's personal deductions, allowances, and credits are usually prorated to reflect the portion of time during the year that the taxpayer is actually resident. In theory, the taxpayer's new country of residence should provide the taxpayer with personal allowances for the balance of the year.

The problems of part-time residents are different from those of deemed residents. For example, as discussed in Chapter 2, section 2.2.1, many countries have **183-day rules** under which persons who are present in the country for more than 183 days in any year are deemed to be residents. These residents are typically deemed to be resident for the entire year, not just for the portion of the year during which they are present in the country. However, part-time residents are considered to be resident for part of a year and nonresident for the remainder of the year.

3.4.4 Foreign Exchange Gains and Losses

As mentioned in section 3.2.4.2 above, residents must generally translate their foreign source income from a foreign currency into the currency of the residence country. This process of currency translation may often result in recognition of gains and losses attributable to changes in the exchange rates between the two currencies, even though there may be no gain or loss with respect to the underlying property or transaction measured in the foreign currency.

For purposes of computing capital gains and losses from the disposal of foreign property, it is inappropriate to simply convert the amount of a capital gain or loss into domestic currency. Instead, the cost of the property in foreign currency should be translated into domestic currency at the exchange rate applicable at the time that the property was acquired, and the proceeds from the sale of the property should be translated into domestic currency at the exchange rate applicable at the time the property is sold. This method of foreign currency translation results in recognition of the foreign currency gains and losses as part of the capital gain or loss from the disposal of the property, as illustrated in the following simple example.

Example

X, a resident of Country R, acquired property in Country S on October 20, 2000, at a cost of EUR 100,000, the currency of Country S. On October 20, 2000, the exchange rate of

the euro relative to Country R's currency was EUR 1 = 1.5 Country R dollars. X sells the property on December 7, 2020, for EUR 100,000. The exchange rate relative to Country R dollars on that date is EUR 1 = 1 Country R dollar. The loss for purposes of Country R tax might be calculated as follows:

Proceeds	EUR 100,000	100,000 Country R dollars
Cost	EUR 100,000	150,000 Country R dollars
Loss		50,000 Country R dollars

Because the dollar has appreciated against the euro, the disposal of the property produces a loss, although there is no gain or loss with respect to the property measured in euros. If the Country R dollar had depreciated relative to the euro (i.e., the exchange rate was EUR 1 = 1 dollar on October 20, 2000, and EUR 1 = 1.5 dollars on December 7, 2020), the taxpayer would have realized a gain of 50,000 Country R dollars, although there would have been no gain or loss in terms of euros.

If the gain or loss is determined in the foreign currency (i.e., the cost and proceeds) and that amount is simply translated into domestic currency at the rate applicable on the date of sale, or perhaps at the average rate applicable for the year in which the sale occurs, foreign exchange gains and losses would not be realized at all. As shown in the previous example, there would be no gain or loss measured in euros despite significant movement in the exchange rate.

Foreign exchange gains and losses may also arise with respect to debt obligations. For example, assume that a taxpayer resident in Country R, whose currency is R dollars, borrows EUR 1,000. At the time of the borrowing, the exchange rate is EUR 1 = 5 Country R dollars. Interest on the loan is 10% annually. Each time that interest of EUR 100 becomes payable (or accrues or is paid), the taxpayer must convert that amount to Country R dollars at the exchange rate applicable at the time the interest becomes payable, or accrues, or is actually paid. When the loan is repaid, the taxpayer will realize a gain or loss depending on whether the Country R dollar has appreciated or depreciated in relation to the euro. For example, if on repayment, the exchange rate is EUR 1 = 4 Country R dollars, the taxpayer will realize a gain of 1,000 Country R dollars. In effect, the taxpayer has borrowed 5,000 Country R dollars but needs only 4,000 Country R dollars to repay the loan. Under domestic law, foreign exchange gain or loss on the repayment or settlement of a debt obligation may be treated as a capital gain or loss or as ordinary income or loss.

Foreign currency risks arise with respect to actual foreign currency transactions as well as other aspects of a taxpayer's business. For example, a taxpayer that sells its products to residents of another country is exposed to the risk that the country's currency may weaken against the taxpayer's currency, with the result that the taxpayer's products become more expensive for residents of the other country.

Businesses often try to manage or hedge their foreign currency risks through natural hedges, such as borrowing in the currency of the country in which they carry on business or own assets, or through derivatives, which are financial products designed to produce a gain or loss that offsets a gain or loss in respect of an underlying

asset or liability. The treatment of these hedges for tax purposes is dependent on a mixture of accounting rules and domestic tax law. Tax treaties do not generally deal with hedging.

another country asserts the right to tax the same income because the income arises or has its source in that country.

Of these three types of international double taxation, overlapping residence-source claims are the most likely to occur. To some degree, taxpayers can minimize their exposure to the other types of double taxation through careful tax planning, but residence-source double taxation is difficult for taxpayers to avoid through tax planning. Therefore, the attempts of the international tax community to deal with international double taxation have focused primarily on the elimination of residence-source conflicts.

International double taxation can also occur due to differences in the way countries define income and the timing and tax accounting rules they adopt for computing income. As explained in Chapter 6, international double taxation may also occur due to disputes between countries about the proper arm's-length prices for cross-border transfers of goods and services between related parties. Other rules adopted to curtail tax avoidance can also produce double taxation. For example, if one country denies the deduction of interest paid by a resident corporation to a shareholder in another country pursuant to thin capitalization or earnings-stripping rules and treats the interest paid as a dividend, the amount may be taxable in both countries, as a dividend subject to withholding tax in one country and as interest included in the resident corporation's income by the other country.

Typically, tax treaties provide relief from the three major types of international double taxation and from some of the other types as well, although the relief is sometimes limited. Some cases of double taxation resulting from overlapping claims based on the source of income are dealt with by explicit rules for the source of income. For example, Article 11(5) of the OECD and UN Model Treaties provides that interest is deemed to arise (i.e., have its source) in the country in which the payer is resident. As noted in Chapter 2, section 2.3.1, however, most tax treaties do not contain extensive source rules. Cases involving source-source double taxation that are not resolved by the specific provisions of a treaty may be resolved through consultation between the competent authorities of the two treaty countries under the treaty's MAP. *See* Chapter 8, section 8.8.3, for a discussion of the MAP. Resolution of such issues is not easy because the competent authorities of most countries are naturally reluctant to give up their country's right to tax what they consider to be domestic source income.

Individual taxpayers almost always obtain relief from international double taxation resulting from dual residence through the tie-breaker rules in tax treaties. Cases involving the dual residence of legal entities may also be resolved by treaty. As discussed in section 2.2.3, Article 4(2) of the OECD and UN Model Treaties provides a series of "tie-breaker" rules to resolve cases in which an individual is resident in both countries under their domestic laws. Until 2017, the dual residence of a legal entity was resolved under Article 4(3) of the OECD and UN Model Treaties by deeming the entity to be resident in the country where its place of effective management was located. However, in the 2017 updates of both model treaties, the place-of-effective-management rule, which proved to be difficult to apply in practice, was eliminated, and the residence of dual-resident entities was left to the competent authorities to resolve

pursuant to the MAP. Since dual-resident entities are often used to avoid tax, some bilateral tax treaties deny treaty benefits to such entities.

Ordinarily, the residence country grants relief from double taxation resulting from the imposition of tax on the same item of income by both the residence country and the source country. In other words, the source country's right to tax on the basis of the source of the income has priority over the residence country's right.

Three methods—the **deduction method**, the **exemption method**, and the **credit method**—are commonly used for providing full or partial relief from double taxation. These methods are discussed in section 4.3 below after a brief explanation of what is meant by the term "international double taxation."

4.2 INTERNATIONAL DOUBLE TAXATION DEFINED

"Double taxation" is used in so many different contexts that any precise definition of the term is not appropriate in all contexts. The term is not defined in the OECD or UN Model Treaties or the Commentary on those Models, although one of their main objectives is "the avoidance of double taxation with respect to taxes on income and on capital."

"**International double taxation**" can be defined as the imposition of income taxes by two or more sovereign countries on the same item of income (including capital gains) of the same taxable person for the same period. This juridical or legal definition of international double taxation is narrow and does not cover many situations that commentators frequently refer to as double taxation, although it does identify the essential ingredients of international double taxation. Even so, under this definition, it is not always easy to determine whether double taxation exists in a particular case. For example, questions may arise as to whether the taxes levied by the two countries are both income taxes or whether the items of income subject to tax are the same.

The legal definition of international double taxation should be distinguished from the broader economic concept of double taxation. **Economic double taxation** occurs whenever there is multiple taxation of the same item of economic income. Under the legal definition, taxation of the profits of a subsidiary company by one country and taxation of the parent company on a dividend from that subsidiary by another country is not international double taxation because the two companies are separate legal entities. In the economic sense, however, the parent and the subsidiary constitute a single enterprise and tax imposed on both the profits of the subsidiary and distributions of those profits clearly constitutes double taxation of the profits. Economic, but not legal, double taxation also may arise when income is taxed to a partnership and the partners or when it is taxed to a trust and the beneficiaries of the trust.

Methods for relieving international double taxation are primarily focused on legal double taxation rather than economic double taxation. The reason double taxation relief is limited to legal double taxation is that the definition of economic double taxation is exceedingly broad and difficult to specify with the precision needed for tax laws. For example, some economic double taxation occurs where income is taxed when earned and again when consumed, yet no country is prepared to extend double