circumstances as an excise tax on the payer, whereas a residence tax generally operates as an income tax on the recipient of the income. As an example of this excise-tax effect of withholding taxes, consider a foreign bank that requires a borrower to make interest payments net of any withholding tax imposed by the source country. In such circumstances, the borrower is likely to view the withholding tax as an additional cost of borrowing.

In theory, zero rates of withholding simplify administration and promote business efficiency by allowing intercompany transfers to be made without tax consequences. In practice, zero rates may promote tax avoidance schemes and, in the absence of complex anti-avoidance rules, may provide unintended benefits through treaty shopping. Treaty shopping occurs, for example, when treaty benefits are obtained by corporations that are nominally resident in a treaty country but are owned beneficially by nonresidents. For a discussion of treaty shopping, see Chapter 8, section 8.8.2.2.

CHAPTER 3

Taxation of Residents

3.1 INTRODUCTION

As discussed in Chapter 2, many countries tax persons – individuals and legal entities – who are residents on their worldwide income and nonresident persons only on their domestic source income. Thus, the essential difference between the taxation of residents and nonresidents is that nonresidents are taxed only on income derived from a country (domestic source income) while residents of a country are taxed on both their domestic source income and their income derived from outside the country (foreign source income). Although a few countries tax only domestic source income (so-called territorial taxation), most countries tax resident persons on at least some of their foreign source income. Therefore, the typical pattern of taxation internationally can be described as the taxation of residents on both their domestic source income and at least some items of their foreign source income. The taxation of nonresidents is dealt with in Chapter 5.

The distinction between resident persons and nonresident persons is a fundamental one and has important consequences. As discussed in Chapter 2, the determination of the residence of a person is usually based on the person's connections to a country, although the specific rules vary considerably from country to country. The closer and more extensive a person's connections are with a country, the more likely it is that the person will be considered to be a resident of that country for purposes of its tax system.

This chapter examines the major issues involved in taxing residents on their worldwide income other than the determination of residence itself, which is dealt with in Chapter 2. Initially, it considers the tax policy reasons for taxing residents on their worldwide income and then several more practical issues, such as the computation of foreign source income, departure or exit taxes, **trailing taxes**, the treatment of temporary residents, and foreign exchange gains and losses.

3.2 TAXATION OF RESIDENTS ON THEIR WORLDWIDE INCOME

3.2.1 Tax Policy Considerations

It may seem initially that countries that impose tax on the worldwide income of their residents are exceeding their sovereign authority to tax because they are taxing income that arises outside their territories **(extraterritoriality)**. However, there are no international law constraints on a country's legal authority to tax persons who have close connections to the country. There are practical constraints on a country's ability to tax, since it makes little sense for a country to impose taxes that cannot be effectively collected. However, tax on the worldwide income of residents can be effectively collected because, by definition, the residents of a country are persons with significant ties to the country.

The tax policy justifications for taxing resident individuals on their worldwide income are equity and neutrality. If two residents have equal amounts of income, they should be subject to the same tax burden, even if one resident's income is derived totally from domestic sources while the other's income is derived exclusively from outside the country. This equity justification is based on the assumption that all residents of a country derive significant personal benefits from the country in the form of public goods and services that justify taxing them irrespective of the source of their income. The neutrality justification is that a country should not create a tax incentive for its residents to work or invest outside the country. If the foreign source income of residents is not subject to residence country tax, residents have an incentive to earn low-taxed foreign source income in preference to domestic source income, and this incentive is detrimental to the domestic economy.

With respect to corporations and other legal entities, considerations of equity are of little significance because such entities are not the ultimate beneficial owners of their income. Accordingly, the justification for taxing legal entities on their worldwide income must rest primarily on the neutrality argument. This form of neutrality is referred to as capital-export neutrality – a taxpayer should invest where the pre-tax return is maximized. To achieve this type of neutrality, a country must tax its resident entities on income from both foreign and domestic investments. If income from foreign countries is not taxed, legal entities resident in a country will prefer to invest in foreign countries with lower tax rates, and especially in tax havens with no or low taxes.

There is, however, another side to the neutrality argument with respect to business income – capital-import neutrality or international competitiveness – which suggests that entities resident in one country must compete in various countries with entities resident in those countries and with third countries. If the entities resident in Country A are subject to tax by Country A on their worldwide income, they will not be able to compete as effectively in Country B as entities resident in Country B or resident in third countries that are subject to tax only in Country B. The arguments concerning international competitiveness, although complex and controversial to academics, have proved irresistible to governments. As a result, it is fair to say that the international norm is that active business income derived by legal entities is generally taxed on a territorial basis; in other words, the foreign source business income derived by a

resident corporation is not usually subject to residence country tax. This point is explained in more detail below.

It might be thought that one of the reasons for a country to tax its residents on their foreign source income is the additional tax revenue that will be generated. However, as explained in Chapter 2, to the extent that such income is subject to tax in the country in which it is derived (the source country), that country has the first right to tax the income. The residence country is generally considered to be under an obligation (although not a legal obligation unless there is a treaty in effect between the two countries) to eliminate double taxation, either by exempting the foreign source income from residence country tax or by providing a credit against residence country tax for the source country tax on the foreign source income. Thus, additional tax revenue will be generated only if the residence country eliminates double tax through a **foreign tax credit** and only to the extent that the source country tax is less than the residence country tax. The **elimination of double tax** is explored in Chapter 4.

3.2.2 The Tax Consequences of Residence

In a worldwide tax system, an individual taxpayer's income includes both income from inside the country in which the taxpayer is resident and income from outside that country. The individual is usually taxable on that worldwide income at progressive rates, although the extent of the progression in the rates may be limited; for example, an amount may be taxable only if the taxpayer's income exceeds a threshold amount. In some countries, although foreign source income is not taxable, it is taken into account in determining the rate of tax on the taxpayer's other income (**exemption with 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 percent, or 1,500, and the interest is subject to withholding tax in Country Z of 10 percent, 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 has its source – 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 the 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 their 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.

Source rules are irrelevant for purposes of determining the worldwide income of residents since all income, domestic and foreign, is taxable. However, source rules are required if any items of foreign source income 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 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 never exceeds the amount of domestic tax on the foreign source income.

Expenses incurred to earn foreign source income are clearly 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, the 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. 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 though dividends received from such corporations are exempt from residence country tax. This issue has become increasingly important as more countries have adopted participation exemptions. The OECD's BEPS Action 4: *Interest Deductions and Other Financial Payments* (December 18, 2014) 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 taxable 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 also 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 country in which it is earned. Similarly, expenses incurred to earn foreign source revenue 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. In theory, each amount 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).

For purposes of computing capital gains from the disposal of foreign property, it is appropriate to translate the cost of the property in foreign currency into domestic currency at the exchange rate applicable at the time that the property was acquired, and to translate the proceeds from the sale of the property at the exchange rate applicable at the time the property is sold. This method of foreign currency translation results in the 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, acquires property in Country S on October 20, 2000 at a cost of € 100,000, the currency of Country S. On October 20, 2000 the exchange rate of the

CHAPTER 5

Taxation of Nonresidents

5.1 INTRODUCTION

As noted in Chapter 2, most countries tax their residents on their worldwide income and nonresidents on their domestic source income (i.e., income earned or derived in a country's territory). A few countries impose tax exclusively on domestic source income (territorial taxation) irrespective of whether the income is derived by a resident or a nonresident. Thus, it is fair to say that all countries, other than pure tax havens, tax the income earned or derived in their territory by nonresidents. For countries that tax on a worldwide basis, it is necessary to have rules that distinguish between residents and nonresidents because nonresidents are taxable only on their domestic source income, not on their worldwide income. The rules for determining whether a person is a resident of a country for income tax purposes are discussed in Chapter 2, section 2.2.

As discussed in Chapters 2 and 3, the international consensus is that countries are entitled to tax any income that arises or has its source in their territory. The rules for determining the source of income are dealt with in Chapter 2, section 2.3. A country's right to tax domestic source income takes priority over the right of another country to tax that income based on the residence of the person deriving the income. For this reason, the residence country has an obligation to relieve international double taxation in recognition of the source country's prior right to tax.

This chapter examines the major issues involved in taxing nonresidents on their domestic source income. The chapter begins with a brief discussion of the policy justification for taxing nonresidents and then deals with practical issues such as threshold requirements, the taxation of business profits and investment income of nonresidents, and the collection of tax from nonresidents.

It is convenient for conceptual purposes to divide the taxation of nonresidents into the following stages:

- A country must determine what type of connection (nexus) a nonresident must have to the country (activities in the country, the ownership of property

in the country, physical presence in the country, etc.) in order for the country to be able to exercise its jurisdiction to tax.
- Once a country has decided that it has jurisdiction to tax, it must decide whether it should exercise that jurisdiction to tax only if the nonresident meets some minimum threshold such as a permanent establishment or fixed base.
- If the threshold is met or the country decides that a threshold is unnecessary, a country must have rules to determine what amounts derived by nonresidents are subject to tax; these rules are usually referred to as source rules.
- Rules are necessary to compute the nonresident's income and tax payable.
- Finally, rules are necessary with respect to the collection of tax from nonresidents.

These stages are intimately connected and often overlap. For example, if a country decides to tax any interest or dividends paid by a resident to a nonresident, the source of the income as represented by the residence of the payer is the connection that gives the country the jurisdiction to tax; accordingly, that country has rejected the necessity for any threshold requirement. Similarly, transfer pricing rules can be viewed as source rules or as computational rules. These stages are set out here to assist in the analysis of the taxation of nonresidents; they do not attempt to describe the ways in which countries actually tax nonresidents.

The distinction between business profits and investment income is particularly important with respect to the taxation of nonresidents. Business income is typically taxed on a net basis at the same rates applicable to resident taxpayers, so that individuals earning business income in another country are often subject to tax at progressive rates. In contrast, investment income is typically taxed at a flat rate on the gross amount; moreover, the tax is usually imposed by way of a withholding tax (i.e., there is an obligation on the resident person paying the amount to the nonresident to withhold the amount of the tax from the payment to the nonresident and to remit the tax to the tax authorities).

5.2 TAX POLICY CONSIDERATIONS IN TAXING NONRESIDENTS

It may be recalled from Chapter 3, section 3.2 that the tax policy justifications for taxing residents on their worldwide income are equity and neutrality. It is difficult to justify taxing nonresidents on the basis of equity because the source country does not have complete information about the nonresident's tax situation; for example, income earned in the source country may be offset by losses incurred in other countries. It is generally impossible for a country to determine whether residents and nonresidents are similarly situated for tax purposes except in situations where all or almost all of a nonresident's income is derived from one country.

In general, however, it is reasonable to say that, to the extent possible, nonresidents should not be treated better or worse than residents in similar situations. The

taxation of nonresidents on their domestic source income can be justified on the basis that nonresidents derive benefits from the source country; for example, nonresidents doing business in a country take advantage of the country's infrastructure and its legal system in the same way as residents. It can also be argued that, even if a nonresident simply sells goods in a country, the nonresident is benefiting from the market provided by that country and that benefit is sufficient to justify taxation.

The principle that nonresidents deriving income from a country should not be treated less favorably than residents of that country – the **nondiscrimination principle** – is an important principle that most countries follow, at least in part. Although it may be tempting for a country to tax nonresidents more harshly than residents – after all, nonresidents do not vote – the likely response of other countries would be to do the same, thus putting the first country's residents at a disadvantage. In practice, there is surprisingly little discrimination against nonresidents in the tax systems of most countries. Many countries do, however, discriminate in favor of nonresidents in certain circumstances by providing them with tax holidays and other tax incentives in order to attract foreign investment. Discrimination in favor of nonresidents is not considered to be offensive, although it is widely criticized by tax policy commentators. The nondiscrimination principle is recognized in Article 24 of both the OECD and the UN Model Treaties. The **nondiscrimination article** in tax treaties is dealt with in Chapter 8, section 8.8.1.

From a revenue perspective, it makes obvious sense for countries to tax nonresidents. However, the need for tax revenue must be balanced against the need for foreign investment. If a country taxes nonresidents too harshly, the effect may be to discourage nonresidents from investing in the country; moreover, other countries can be expected to respond by taxing that country's residents equally harshly. Thus, countries that import and export capital and tax on a worldwide basis have interests as both residence countries and source countries that must be balanced. As residence countries, they want to minimize tax imposed by source countries on the foreign source income of their residents and to ensure that their residents are not discriminated against relative to the residents of source countries. As source countries, they want to attract foreign investment but also want to tax nonresidents as heavily as possible. These competing interests cannot all be achieved fully because of the inevitable retaliation by other countries that would result.

Another important consideration in the taxation of nonresidents is enforcement. On the one hand, it obviously makes no sense for a country to impose tax on nonresidents that cannot be enforced effectively. On the other hand, it may not make sense for a country to tax all the income derived by nonresidents that can be enforced effectively. Most countries do not follow the practice of taxing nonresidents on everything that they can tax, probably because, as noted above, they do not want other countries to do the same and they want to attract foreign investment. Nevertheless, it is probably fair to say that countries seriously consider taxing nonresidents to the maximum extent possible unless there is some good reason not to.

5.3 THRESHOLD REQUIREMENTS

Although there is no restriction on the authority of a country to tax any and all domestic source income derived by a nonresident, few countries do so – most countries tax nonresidents on certain types of income only if a minimum threshold is met. For example, many countries tax nonresidents on their business income only if the income is attributable to a PE in the country. This threshold for the taxation of business profits is also used in Article 7 of the OECD and UN Model Treaties. Even countries that do not use the PE concept in their domestic law usually tax nonresidents on their business income only if their business activities exceed some threshold; for example, in the United States nonresidents are taxable on their business income only if they are engaged in a trade or business in the United States.

There are several reasons for the establishment of a threshold requirement for the taxation of nonresidents. First, serious compliance and enforcement problems arise when nonresidents are taxable on all domestic source income. It is difficult for tax authorities to identify all nonresidents earning income from the country and to get information about that income. (Consider, for example, the difficulties in taxing a consultant who performs services in a country for a few days.) Moreover, unless a nonresident has some type of substantial and continuing presence in a country, it may be difficult or impossible for the country to collect its tax. Second, as noted in Chapter 2, section 2.3, few countries have detailed source rules; as a result, a threshold requirement can provide more certainty for nonresidents as to when they become subject to tax by a country. Third, requiring nonresidents to file tax returns and pay tax on relatively small amounts of income is likely to discourage cross-border trade and investment or result in nonresidents ignoring their tax obligations.

Threshold requirements for taxing nonresidents are provided by domestic law and tax treaties and differ depending on the type of income. Some common thresholds are described below:

- *Business profits*: The threshold provided by tax treaties is the existence of a PE in a country. In general, a PE is a fixed place of business or a dependent agent with authority to contract on behalf of the nonresident. Certain types of business profits, such as income derived by entertainers and athletes, are usually subject to a lower threshold. The UN Model Treaty uses a 183-day threshold for the taxation of income from services derived by nonresidents and has a special provision for insurance businesses.
- *Income from immovable property:* The immovable property must be located in the country.
- *Employment income:* As a general rule, the threshold is the physical presence of the employee in the country and the performance of the duties of employment in the country, although under tax treaties the source country is precluded from taxing a nonresident employee of a nonresident employer without a PE in the source country, unless the employee is physically present for more than 183 days.

- *Investment income:* Typically, there is no threshold for source country taxation of dividends, interest, and royalties under domestic law or treaties. As discussed below, the source country tax is imposed as a final withholding tax at a flat rate on the gross amount of the payment.

In general, thresholds for the taxation of nonresidents take the form of a fixed place (either a fixed place of business or immovable property) or the physical presence of the nonresident in the country (sometimes for a specified period). Thresholds based on the amount of revenue or income derived by a nonresident are rare in both domestic law and treaties.

5.4 SOURCE RULES

Once it has been determined that a country has jurisdiction to tax a nonresident and that any threshold for taxation has been met, it is necessary to have rules to determine what amounts are subject to tax and how those amounts are taxed. In general, countries tax nonresidents only on their domestic source income. As a result, source-of-income rules are necessary to determine whether a nonresident's income is derived from sources inside the territory of the country. Sometimes these source rules are explicit: for example, a country's tax law might provide that a nonresident is taxable on domestic source income and then list items or amounts that are considered to be from domestic sources. More often, however, countries simply prescribe the amounts derived by nonresidents that are subject to tax, without explicit reference to the source of those amounts. For example, a country might impose tax on dividends paid by a resident corporation to a nonresident. The source rule in this case is implicit – in effect, dividends are considered to have their source in the country in which the company paying the dividends is resident. Except in cases where the income is taxed on a gross basis, it is also necessary to determine what expenses are deductible in determining the domestic income subject to tax. Source rules are discussed in more detail in Chapter 2, section 2.3.

5.5 DOUBLE TAXATION

In situations where a resident of one country earns income sourced in another country, by international consensus the country in which the income is earned has the first right to tax the income, and the residence country has a corresponding obligation to relieve international double taxation by exempting the income from tax or providing a credit for the source country tax. Therefore, in taxing nonresidents, countries do not need to be concerned about eliminating double taxation of this type. The only type of double taxation that source countries should be concerned about is where two countries both claim that the relevant item of income has its source in their country. Accordingly, the more expansive a country's source rules are, the more likely it is that its source claims will overlap with other countries' source claims.

5.6 EXCESSIVE TAXATION OF NONRESIDENTS

Although source countries do not need to be concerned about the elimination of double taxation except in the case of overlapping source rules, they should be concerned about the excessive taxation of nonresidents. As discussed below, certain types of income are typically taxed by withholding at a flat rate on the gross amount of the payment. In these situations, there is a risk that the source country tax may be excessive relative to the net income derived by the nonresident. For example, consider a situation in which a nonresident incurs substantial expenses to earn royalties in a country. If the source country taxes the royalties at a flat rate of 30 percent without any recognition for the expenses, the nonresident may realize little, if any, after-tax profit from the transaction. If the residence country exempts foreign source royalties, it will not provide any relief for the source country tax; and even if the residence country provides a foreign tax credit, the limitation on the credit (see Chapter 4, section 4.3.3 for a discussion of the limitations on a foreign tax credit) will likely result in the taxpayer getting only partial relief for the source country tax. The overall result is that the royalties may be taxable at an effective rate that is considerably higher than the residence country tax rate. Sometimes nonresidents may be able to avoid excessive source country taxation by requiring the resident payers to effectively absorb the tax by grossing up the payments. Such excessive source country tax may be borne by residents or may discourage foreign investment.

5.7 COMPUTATION OF THE DOMESTIC SOURCE INCOME OF NONRESIDENTS

In general, the rules for computing the income of nonresidents are the same as the rules applicable to residents. Thus, the rules that determine what amounts are included in income, what deductions are allowable, and the timing of income and deductions are applicable equally to residents and nonresidents. For example, if a country allows a deduction for only a portion of a taxpayer's entertainment expenses, that rule will apply equally to nonresidents. Although in general the rules for computing the income of residents and nonresidents are the same, there are some exceptions. For example, transfer pricing rules apply to transactions between a resident and a related nonresident and not to transactions between related residents. Transfer pricing rules are discussed in Chapter 6. Similarly, thin capitalization rules are typically applicable only to interest paid by a resident corporation to nonresidents, although in a few countries the rules also apply to interest paid to tax-exempt residents. Conversely, controlled foreign corporation (CFC) rules apply only to nonresident companies that are controlled by residents of a country. Thin capitalization rules and CFC rules are dealt with in detail in Chapter 7, sections 7.2 and 7.3 respectively. It should be noted in this regard that the case law of the European Court of Justice has severely restricted the ability of an EU member country to have rules, such as thin capitalization rules or CFC rules, that apply differently to residents of that country and residents of another EU member country.

As discussed below in section 5.8, the nondiscrimination article of an applicable tax treaty requires the source country to allow nonresidents to deduct expenses in computing the profits attributable to a PE on the same basis as residents engaged in similar activities. However, where nonresidents are subject to tax on a gross withholding tax basis, no deductions are allowed. Therefore, the distinction between amounts such as business profits, which are subject to net-based taxation, and amounts such as investment income, which are subject to withholding tax, is very important. This distinction is discussed in section 5.8.1 below.

With respect to nonresident individuals, personal deductions, reliefs, allowances and credits are not customarily provided by source countries. For example, many countries provide a basic personal or family exemption from tax so that if an individual's or family's income does not exceed the minimum amount, no tax is payable. Similarly, many countries provide deductions or allowances for family members who are dependent on the taxpayer for support. These and other similar personal allowances are not generally provided by countries to nonresidents, and the typical nondiscrimination article in tax treaties does not require such allowances to be extended to nonresidents.

As mentioned above, there are no legal constraints to prevent a source country from treating nonresidents more favorably than residents. In particular, many developing countries provide nonresident investors with special tax incentives that are not available to residents.

If a country imposes a final withholding tax on the gross amount of certain payments, such as dividends, interest, and royalties, no computational rules are necessary since the gross amount is taxable. If, however, the withholding tax is imposed on an interim basis on account of a nonresident's final tax liability, rules for the computation of net income are necessary. Some South American countries impose final withholding taxes on a wide range of payments made to nonresidents. In many cases, the tax is imposed at a fixed rate on a fixed percentage of the payment rather than on the gross amount. Taxing a presumptive amount in this way represents an attempt to give relief for the expenses incurred to earn certain types of income without the necessity for either the taxpayer or the tax authorities to calculate a particular nonresident's actual income.

5.8 TAXATION OF VARIOUS TYPES OF INCOME OF NONRESIDENTS

5.8.1 Business Income

5.8.1.1 In General

Because business income earned by nonresidents is usually taxed on a net basis and investment income is taxed on a gross basis, it is important to distinguish between the two types of income. In some civil law countries, all the income earned by a legal entity is characterized as business income, and therefore it is necessary to distinguish

problems that Member States encounter in determining the amount of income derived by corporations from activities occurring within their borders. However, agreement on a common consolidated tax base has been elusive.

The OECD has approved the use of formulas for apportioning the income of corporate groups engaged in global trading, banking, and insurance. Therefore, current transfer pricing rules are a mix of arm's-length methods and formulary apportionment methods. Given the deficiencies of both the arm's-length method and formulary apportionment, as well as the difficulty of changing the existing system, it seems likely that transfer pricing will continue to be a complex mixture of rules that, despite continuous refinement, will never deal with the underlying problem in a satisfactory manner.

CHAPTER 7

Anti-avoidance Measures

7.1 INTRODUCTION

International transactions provide many opportunities for the avoidance of tax. In this context, tax avoidance must be distinguished from **tax evasion**, which is illegal and usually involves the intentional nondisclosure of income or fraud. **Tax avoidance** is difficult to define precisely, but generally means transactions or arrangements entered into by a taxpayer in order to minimize the amount of tax payable in a lawful manner.

The ways of avoiding tax through international transactions are far too numerous to itemize. The following examples, however, illustrate the range of possibilities:

- A taxpayer can shift his or her residence from one country to another country that levies lower or no taxes.
- A taxpayer can divert domestic source income to a controlled foreign entity, such as a trust or a corporation, established in a tax haven.
- A taxpayer can establish a tax haven subsidiary to earn foreign source income or to receive dividends from subsidiaries in other foreign countries.
- If advantageous treaties exist, a taxpayer can route dividends, interest, royalties, and other amounts through subsidiaries established in foreign countries in order to reduce the amount of withholding tax on such amounts.

Not surprisingly, most countries have anti-avoidance rules to deal with certain types of international tax avoidance, and some countries still have exchange controls to regulate foreign investments and transactions by residents. Although these controls can be effective in preventing international tax avoidance, over the past several decades countries have abandoned exchange controls in favor of the free movement of capital.

Countries that do not use exchange controls employ a wide variety of tax measures to combat international tax avoidance. Some important examples of such

measures are described briefly below, with references in some instances to more detailed treatment elsewhere in the Primer.

Anti-avoidance rules and doctrines. Many countries have judicial anti-avoidance doctrines or statutory anti-avoidance rules under which transactions may be disregarded for income tax purposes. These doctrines and rules apply generally to tax avoidance transactions or arrangements, including international transactions. Judicial anti-avoidance doctrines include the sham transaction, substance-over-form, business purpose, step transaction and abuse of law doctrines. For example, the existence of a holding company established in a tax haven may be disregarded as a sham if it does not engage in any genuine commercial activities. Statutory anti-avoidance rules include specific and general anti-avoidance rules. Specific anti-avoidance rules include transfer pricing rules, thin capitalization and earnings-stripping rules, controlled foreign corporation (CFC) rules, and foreign investment fund rules. General anti-avoidance rules (often referred to by the acronym "GAAR") are intended to be sufficiently broad to deal with most or all types of abusive tax avoidance, including international tax avoidance transactions. Typically, GAARs apply when the principal purpose or one of the principal purposes of a transaction or a series of transactions is to avoid tax and the transaction abuses, frustrates, or defeats, or is inconsistent with, the object and purpose of the relevant tax legislation.

Special tax haven provisions. Some countries have specific provisions designed to deal with particular tax haven abuses. For example, Germany imposes a special tax on persons who move their domicile to a tax haven. Other countries disallow the deduction of interest and royalty payments or payments for services made to a tax haven entity unless the taxpayer establishes that the transactions are genuine; in other words, the onus of proof is placed on the taxpayer to justify such deductions.

Transfer pricing rules. Most countries have intercompany or transfer pricing rules to prevent related taxpayers from carrying out transactions at artificially high or low prices in order to shift income and expenses from one country to another. It is arguable whether these rules are properly classified as international anti-avoidance rules or whether they are just part of a country's basic tax system. Transfer pricing rules are discussed in detail in Chapter 6.

CFC rules. Several countries have adopted CFC rules to prevent the diversion of passive and certain other income to, and the accumulation of such income in, a CFC established in a tax haven. These rules are discussed in section 7.3 below. Some countries have similar rules with respect to foreign trusts.

Foreign investment fund rules. Several countries have adopted foreign investment fund rules to prevent the deferral of domestic tax by residents investing in foreign mutual funds, unit trusts, or similar entities. These rules are discussed in section 7.4 below.

Anti-treaty shopping rules. Several countries insist on the inclusion of provisions in their tax treaties and/or in their domestic legislation to prevent treaty shopping. Treaty shopping typically involves the establishment of a legal entity in a country by

nonresidents in order to obtain the benefits of the country's tax treaties. Treaty shopping is discussed in Chapter 8, section 8.8.2.2.

Thin capitalization and earnings-stripping rules. Several countries have adopted **thin capitalization** and **earnings-stripping rules** to limit the deduction of interest by resident corporations and other legal entities. Thin capitalization rules are intended to prevent nonresident shareholders of resident corporations from using excessive debt capital to extract corporate profits in the form of deductible interest rather than non-deductible dividends. Earnings-stripping rules are more broadly targeted at resident corporations and other entities that claim disproportionately large interest deductions. These rules are discussed in section 7.2 below.

Taxation of gains on transfers of property abroad and on expatriation. When appreciated property – property with an accrued gain – is transferred to a related nonresident, some countries deem the property to have been sold for its fair market value so that the accrued gain is subject to tax. Otherwise, domestic tax on the gain might be avoided entirely. Further, some countries impose tax on accrued gains when a taxpayer ceases to be resident or for a temporary period after a taxpayer ceases to be resident; such exit or departure taxes and trailing taxes are discussed in Chapter 3, sections 3.4.1 and 3.4.2.

Back-to-back arrangements. **Back-to-back arrangements** are commonly used as a tax planning device to obtain tax benefits that would not otherwise be available to a taxpayer directly. For example, a country may have rules dealing with related-party transactions; these rules can sometimes be avoided by inserting an arm's-length intermediary between the related parties. Similarly, the benefits of a country's treaties, such as reductions in withholding taxes, may be inappropriately obtained through back-to-back arrangements. Such arrangements are particularly common with respect to financial transactions, since funds can be funneled through an arm's-length financial institution with relative ease. For example, assume that Country A exempts interest payments by corporations resident in Country A to arm's-length nonresidents from its withholding tax on interest. If ACo, a corporation resident in Country A, pays interest to BCo, a related corporation resident in Country B, the interest would be subject to Country A's withholding tax. However, if BCo puts funds on deposit with a financial institution that deals at arm's length with both ACo and BCo and the financial institution loans an equivalent amount to ACo, Country A's withholding tax would not apply to the interest payments by ACo to the financial institution.

Hybrid entities and hybrid financial instruments. A "hybrid" arrangement refers to situations in which two countries treat entities, transactions, or arrangements differently and the different treatment is exploited to produce tax benefits. For example, if one country treats preferred shares issued by a resident corporation in accordance with their legal form as shares on which dividends are paid, but another country treats the shares as debt on which is interest is paid, this inconsistent treatment can be exploited to produce tax savings. If the country in which the corporation is resident treats the payments on the shares as interest, the payments will be deductible

and reduce that country's tax base. If the country in which the recipient of the payments is resident treats the payments as dividends, it may exempt those dividends from tax as a result of its participation exemption. Hybrid arrangements are discussed in more detail in Chapter 9, section 9.3.

7.2 RESTRICTIONS ON THE DEDUCTION OF INTEREST: THIN CAPITALIZATION AND EARNINGS-STRIPPING RULES

7.2.1 Introduction

When a resident corporation pays interest to nonresidents, the interest is usually deductible by the payer in computing income unless there are special rules to the contrary. The interest payments may be subject to withholding tax, but the rate of withholding tax may be substantially reduced or completely eliminated pursuant to an applicable tax treaty. The nonresident lender may or may not be subject to tax on the interest in its country of residence. If the nonresident lender is also the controlling shareholder of the resident corporation, the nonresident lender/shareholder will usually have a choice of financing its subsidiary with debt or equity and extract the profits of the subsidiary by receiving either dividends or interest.

Unlike interest, dividends paid by a resident corporation generally are not deductible. Accordingly, income earned by a resident corporation and distributed to its shareholders is subject to two levels of tax – corporate tax when the income is earned by the corporation, and shareholder tax when the income is distributed to the shareholders as a dividend. If the shareholder is a nonresident, the shareholder tax is usually imposed as a withholding tax.

In contrast, income earned by a resident corporation and distributed in the form of interest to a nonresident lender who is also a shareholder of the corporation is subject to only one level of tax. Because the interest is deductible by the corporation, usually the only source country tax is the withholding tax on the interest payment to the nonresident, and many countries have reduced or eliminated their withholding taxes on interest, either unilaterally or under their tax treaties. The advantage of paying interest to nonresident shareholders compared to paying dividends constitutes an inherent bias in favor of debt financing of resident corporations by nonresident investors. This bias is illustrated in the following example.

NCo, a nonresident corporation, owns all the shares of RCo, a resident corporation. RCo requires capital of one million to finance its business activities. To provide that capital, NCo can either subscribe for one million in additional shares of RCo, or it can loan RCo one million (or some combination of debt and equity). RCo earns income, before the payment of interest or dividends, of 100,000 and distributes its entire after-tax income as a dividend. The arm's-length interest rate payable on loans is 10 percent, and the applicable rates of withholding tax are 5 percent on dividends and 10 percent on interest. A comparison of the tax results of advancing funds by way of debt and equity are set out in Table 7.1.

Table 7.1 Relative Advantages of Debt and Equity Finance

	Debt	*Equity*
Corporate income before payment of interest or dividends	100,000	100,000
Deduction of interest	100,000	not applicable
Taxable income	nil	100,000
Corporate tax (40%)	Nil	40,000
Dividends	not applicable	60,000
Withholding tax (10%, 5%)	10,000	3,000
Total tax	10,000	43,000

As this example illustrates, financing a resident corporation with debt is considerably more effective in reducing the source country tax than financing with equity. The major reason is that interest is deductible, whereas dividends are not deductible. In addition, a resident corporation can repay a loan at any time without triggering tax, whereas it may not be able to repay equity investments (redeem shares or reduce capital) without triggering a taxable dividend.

In response to the bias in favor of debt compared with equity, several countries have adopted restrictions on the deduction of interest paid to nonresidents, or on the deduction of interest more generally. Under "thin capitalization" rules, the deduction for interest paid by a resident corporation to a nonresident controlling shareholder is denied to the extent that interest deductions claimed by the corporation are considered to be excessive. Under these rules, interest is considered to be excessive to the extent that the corporation's debt relative to its equity exceeds a fixed debt:equity ratio (often 1.5:1 or 2:1). The term "thin capitalization" is apt because the rules apply only when a corporation's equity capital is small in relation to its debt. Under earnings-stripping rules, interest is considered to be excessive if it exceeds a financial formula based on the earnings of the corporation (often 25-30 percent of earnings before the deduction of interest, taxes, depreciation and amortization, or "EBITDA").

The problem of deductible interest payments that erode a country's tax base relates primarily to payments to nonresidents. Interest payments to residents are not generally problematic because the residents receiving the payments are usually taxable on those payments. However, EU countries are prohibited from discriminating against residents of other EU countries, and the European Court of Justice has ruled that thin capitalization rules that are applicable only to interest payments to nonresidents are invalid insofar as they apply to residents of other EU countries. Consequently, some European countries have revised their thin capitalization rues so that they apply to all interest payments by resident corporations, including such payments to residents. Other countries have adopted earnings-stripping rules that apply to all interest payments by resident corporations irrespective of the residence of the recipient.

Some countries try to deal with the problem of excessive interest deductions by adopting statutory thin capitalization or earnings-stripping rules; others rely on

administrative guidelines or practices. Still others have applied transfer pricing or GAARs. The statutory rules of the various countries differ considerably. In some countries, thin capitalization rules are seen as specific transfer pricing rules for interest that are limited to interest payments to related or non-arm's-length parties. In other countries, the rules are targeted at interest payments that are viewed as disguised dividends: in other words, debt held by nonresident shareholders with a substantial interest in a resident corporation. Other countries consider the rules to be aimed at interest payments generally.

Although most countries' thin capitalization rules are targeted at certain interest payments – rather than all interest payments – to nonresidents, it must be recognized that all deductible interest payments by residents to nonresidents reduce or erode a country's tax base. Nevertheless, not all base-eroding payments are objectionable; many deductible payments by residents to nonresidents, including interest, represent legitimate income-earning expenses.

7.2.2 The Structural Features of Thin Capitalization and Earnings-Stripping Rules

Typically, thin capitalization and earnings-stripping rules have most of the following structural features.

Nonresident lenders. Thin capitalization and earnings-stripping rules generally apply only to interest paid to nonresidents who own a significant percentage of the shares of a resident corporation. The level of share ownership varies from a substantial interest in the shares (10-25 percent) to control (more than 50 percent of the shares) of the resident corporation. However, some countries, such as Australia, also apply their rules to resident corporations that use debt to finance foreign investment (so-called outbound thin capitalization rules). Moreover, as noted above, several European countries apply their rules to interest paid to both resident and nonresident lenders.

Domestic entities. The thin capitalization rules of most countries apply only to resident corporations. However, the stripping of profits through the payment of excessive interest to related persons may also arise with respect to partnerships and trusts and branches (PEs) of nonresident corporations. As a result, countries are increasingly extending the application of their thin capitalization rules to these entities.

Determination of excessive interest. Generally, thin capitalization and earnings-stripping rules apply only to certain "excessive" interest paid to nonresidents by resident corporations. Countries use a variety of different approaches to determine what constitutes excessive interest; there is no international consensus on this issue. The most common approach is the use of a fixed debt:equity ratio, under which only interest on a corporation's debt that is artificially large in relation to its equity – in effect, debt that is disguised equity – is not deductible. An alternative approach, recommended by the OECD for tax treaties, attempts to characterize debt and equity by reference to all the facts and circumstances, including the debt:equity ratio of the resident corporation. According to the OECD, this approach is consistent with the

arm's-length standard used for transfer pricing generally and avoids the inflexibility and arbitrariness of applying a fixed debt:equity ratio.

Under the earnings-stripping rules used by the United States (US) and several European countries, excessive interest is determined by reference to the relationship between a corporation's interest expenses and its income. A corporation is generally not entitled to deduct interest paid to certain nonresident shareholders to the extent that the interest exceeds a percentage of its income. The US approach is a combination of an earnings-stripping rule, under which interest in excess of 50 percent of a corporation's income is not deductible, and a thin capitalization rule, under which corporations that have a debt:equity ratio of no greater than 1.5:1 are not subject to the earnings-stripping rule. Under the German earnings-stripping rules, the deduction of interest by Germanresident corporations that are part of a corporate group is denied if the interest exceeds 30 percent of EBITDA, unless the German corporation is excessively leveraged compared to the group as a whole.

The OECD's BEPS Action 4: *Limiting Base Erosion Through Interest Payments and Other Financial Payments* recommends that countries should restrict interest deductions based on the net interest expense of the worldwide group as a percentage of the group's earnings (EBITDA). Thus, interest deductions of any resident corporation would be limited by reference to the earnings of the group as a whole rather than by an arbitrary debt:equity ratio. One of the difficulties with this approach is that it requires the tax authorities to have information about the interest expenses and earnings of the worldwide group.

One significant difference between the determination of excessive interest on the basis of earnings or a fixed debt:equity ratio is that earnings are sensitive to fluctuations in interest rates, whereas a fixed debt:equity rule is not. Thus, although a corporation may be better able to carry additional debt if interest rates decline, this fact is irrelevant under a fixed debt:equity ratio. However, under an earnings approach, taxpayers have an incentive to reduce their debt during periods of rising interest rates in order to avoid restrictions on the deduction of interest.

Computation of a debt:equity ratio. A debt:equity ratio for purposes of thin capitalization rules can be established either:

- as an arbitrary ratio, computed on a **consolidated** basis, ignoring any intercompany debt and equity; or
- by reference to the average debt:equity ratio for all resident corporations or all resident corporations engaged in a particular industrial or commercial sector.

Most countries seem to use an arbitrary debt:equity ratio of 1.5:1 to 3:1, sometimes with a higher ratio for financial institutions. The calculation of debt and equity as components of the ratio necessitates many subsidiary tax policy decisions. For example, should all debt held by nonresidents be taken into account, or just debt held by substantial nonresident shareholders? Should equity include contributed surplus or only share capital and retained earnings? How should hybrid securities such as preferred shares be classified? Should debt that is guaranteed by a nonresident shareholder be taken into account? Should a corporation's gross debt be reduced by

CHAPTER 9
Emerging Issues

9.1 INTRODUCTION

This chapter deals with several important recent developments in international tax. Although many of these developments have been mentioned in previous chapters, they are dealt with in detail here for convenience. There is no overarching theme to the topics dealt with in this chapter other than the fact that they have become increasingly important in recent years.

The issues discussed in this chapter are wide-ranging. They include international aspects of domestic law and tax treaties, substantive issues, and administrative issues such as exchange of information and arbitration.

The prominence of the issues discussed here is largely attributable to the work of the OECD and the United Nations (UN). The OECD has become a dominant player with respect to international tax issues, as the recent G-20/OECD BEPS project shows. In recent years, the UN, through the Committee of Experts and its Capacity Development Unit, has also started to exert an increasingly important influence in the international tax arena. For example, the proposal to add a new article to the UN Model Treaty dealing with fees for technical services, discussed in section 9.4 below, represents a potentially important step in the evolution of tax treaties.

9.2 BASE EROSION AND PROFIT SHIFTING (BEPS)

9.2.1 Introduction

Since 2012, the OECD's BEPS project has dominated the international tax agenda. As discussed below in section 9.2.3, the scope of the project is huge, comprising fifteen action items, and the time frame for its completion – the end of 2015 – is unrealistically tight. The project involves not only OECD member countries, but also G20 and developing countries. Many of the action items are discussed elsewhere in this Primer.

This section presents an overview of the BEPS project and its implications for the international tax system. It is important to understand that the problems with the international tax system targeted by the BEPS project are not new. Many of them involve fundamental structural features of the allocation of taxing rights between source and residence countries that countries and international organizations, such as the OECD and the UN, have struggled with for decades. As background for understanding the BEPS project, section 9.2.2 discusses the OECD's first attempt to deal with some of the fundamental problems of the international tax system – the harmful tax competition initiative of the late 1990s.

9.2.2 The 1998 OECD Harmful Tax Competition Report

Over the last fifty years, the proliferation and increased use of tax havens and preferential regimes in otherwise high-tax countries has been staggering. Many developments have contributed to this phenomenon, including:

- the elimination of exchange controls and the liberalization of cross-border trade and investment;
- improved communications, transportation, and financial services;
- the globalization of tax advisory firms;
- the adoption of flexible commercial regimes and strict bank secrecy and confidentiality requirements by tax havens; and
- aggressive marketing.

Tax havens and countries with preferential regimes have become very sophisticated in marketing their services to every geographical region of the world and to every conceivable tax planning need. Although the competition among them is fierce, the field remains crowded, with newer havens and regimes continually being introduced to try to get a piece of the action.

This proliferation of low-tax regimes and their base-eroding effects are what the OECD has called a "race to the bottom." Concern about this race to the bottom led to the OECD and European Union (EU) initiatives against harmful tax competition in the late 1990s. After years of work and difficult negotiations, the OECD issued a *Report on Harmful Tax Competition* in April 1998. The EU adopted a Code of Conduct concerning harmful tax competition in December 1997 (Commission of the European Communities, *A Package to Tackle Harmful Tax Competition in the European Union)*. Although the two initiatives were complementary, the EU Code of Conduct was considerably broader than the OECD Report because it was not limited to geographically mobile activities (the OECD Report was limited to geographically mobile activities, including financial services). The Report recognized that harmful tax competition also occurs with respect to non-mobile activities, such as manufacturing and personal savings, but these activities were left for future action because they were considered more difficult to deal with.

Although the OECD Report was targeted at "harmful tax competition," no definition of that expression was provided in the Report. This shortcoming was

understandable because the term is impossible to define precisely. The use of the term "competition" was perhaps unfortunate because in an era of global free trade and capitalism, it was an article of faith that all competition is good. However, the essential concept inherent in the term "harmful tax competition" is that there is a difference between the type of tax competition that led to a worldwide lowering of tax rates and broadening of tax bases in the late 1980s, and harmful tax competition, which involves the race to the bottom described earlier. According to the OECD, although every country has the sovereign right to determine its own tax policy, a country should not enact policies intended to "poach" the tax base of other countries.

The OECD Report targeted both tax havens and harmful preferential tax regimes, including such regimes in the tax systems of OECD member countries. The Report also suggested a lengthy list of countermeasures that countries might take on both a unilateral and a coordinated basis to deal with tax havens and low-tax regimes. However, the OECD soon abandoned the idea of sanctions against tax havens in favor of a strategy of dialogue and cooperation.

The harmful tax competition initiative was significant because it signaled the beginning of serious international cooperation in fighting tax evasion and avoidance. However, the OECD's action was very controversial. It was accused by some commentators and several smaller tax haven countries of being a cartel of rich countries dictating to small, underdeveloped countries, and of trying to impose a particular type of tax system – an income tax – and a minimum rate of tax. Other commentators, however, have welcomed the OECD initiative as the next logical step for countries to take to protect their domestic tax bases.

Any major new tax policy initiative is a political issue, and the harmful tax competition project was no exception. In late 2000, the United States (US), which until that time had been an enthusiastic supporter of the harmful tax competition project, effectively compelled the OECD to refocus the project almost exclusively on exchange of information. As a result, the OECD committed to developing standardized exchange-of-information provisions in both bilateral and multilateral formats, dealing with both criminal and civil tax matters; its efforts have resulted in a much more effective and efficient system with respect to exchange of information. Exchange of information is discussed in Chapter 8, section 8.8.4.

Although the original goal of the OECD's project was changed from eliminating harmful tax competition to the more modest goal of effective exchange of information, the project has produced some significant results. For example, the Commentary on Article 1 of the OECD Model Treaty was revised extensively in 2001 to clarify the relationship between tax treaties and domestic anti-avoidance rules. This issue is discussed in Chapter 8, section 8.8.2. Also, some of the most obvious preferential tax regimes in OECD member countries have been eliminated.

9.2.3 The G20/ BEPS Project

In retrospect, it was only a question of time before pressures on countries' tax revenues led to additional efforts to protect their domestic tax bases from the tax planning

strategies of multinational enterprises; these efforts gained momentum during the financial crisis of 2008. In 2012, the OECD launched its project against BEPS. The project received a shot in the arm when aggressive tax-planning techniques used by several US multinationals, including Apple, Amazon, Starbucks, and Google, came under intense criticism by European and American politicians.

The BEPS initiative was a natural outgrowth of the OECD's work on exchange of information as a tool to combat international tax avoidance, although the impetus for the project was the final declaration of the meeting of the G20 finance ministers in June 2012, which emphasized "the need to prevent base erosion and profit shifting." In February 2013, the OECD responded to the G20's concerns by issuing a short note, "Addressing Base Erosion and Profit Shifting," that identified several areas for action and deadlines for the implementation of responses. The G20 finance ministers meeting in February 2013 welcomed the OECD report and strongly supported the initiative in the following terms:

> We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July.

On July 19, 2013 the OECD released a detailed *Action Plan on Base Erosion and Profit Shifting* (OECD Action Plan). This Action Plan sets out an ambitious agenda with tight deadlines; it consists of the following actions:

(1) Develop rules to allow countries to impose direct and indirect taxation on electronic commerce (the digital economy) (electronic commerce is dealt with in section 9.6).
(2) Develop treaty provisions and recommendations for domestic rules to deal with hybrid mismatch arrangements involving the use of hybrid entities and hybrid financial instruments (the BEPS proposals with respect to hybrid entities and hybrid financial instruments are discussed in section 9.3).
(3) Develop proposals to strengthen controlled foreign corporation rules (the BEPS proposals with respect to CFC rules are discussed in Chapter 7, section 7.3).
(4) Develop recommendations to deal with base erosion through interest and other financing expenses (the BEPS proposals with respect to interest deductions are discussed in Chapter 7, section 7.2).
(5) Develop more effective countermeasures for harmful tax practices.
(6) Develop treaty anti-abuse provisions and recommendations for the adoption of domestic anti-abuse rules (the BEPS proposals with respect to treaty abuse, including treaty shopping, are discussed in Chapter 8, section 8.8.2.3).
(7) Revise the definition of permanent establishment (PE) in the OECD Model Treaty to prevent the use of commissionaire and other arrangements to avoid PE status (the BEPS proposals with respect to the definition of a PE are discussed in Chapter 8, section 8.7.3.2).

(8) Revise transfer pricing rules to ensure that transfer pricing cannot be used for base erosion and profit-shifting purposes (the BEPS proposals with respect to transfer pricing are discussed in Chapter 6).
(9) Develop methodologies for the collection and analysis of data concerning BEPS and for the evaluation of the effectiveness of measures to counteract BEPS.
(10) Develop measures to require the disclosure of aggressive tax planning arrangements.
(11) Improve transfer pricing documentation (see Chapter 6, section 6.8).
(12) Improve the treaty process for the resolution of disputes, including arbitration (the resolution of tax disputes is discussed in Chapter 8, section 8.8.3, and arbitration is discussed below in section 9.5).
(13) Develop a multilateral treaty to implement BEPS countermeasures and to amend bilateral treaties (the multilateral treaty is discussed in Chapter 8, section 8.8.2.3).

The OECD's BEPS Action Plan is obviously an ambitious one, even taking into account the fact that the OECD had been working on some of the issues, such as hybrid mismatch arrangements and transfer pricing, before the announcement of the BEPS project. It is even more ambitious considering the timeframe for the delivery of the OECD's recommendations. Only the work on the transfer pricing aspects of financial instruments, part of the work on harmful tax practices, and the development of a multilateral treaty was scheduled to take more than two years. With respect to the other issues, OECD recommendations were due to be completed by September 2014 or September 2015. The OECD has adhered to this timetable, although it has acknowledged that work on many of the issues will necessarily continue after 2015. The tight timing of the BEPS project emphasizes the importance of the work to the OECD and the G20; however, it also raises some concerns about the quality of the work produced under such tight time constraints.

At this stage, several general comments about the BEPS project seem appropriate. First, the project has gained widespread support from the G20, which includes Brazil, Russia, India, China, and South Africa (the so-called BRICS), as well as from developing countries. The work is supported by the UN, the World Bank, and the International Monetary Fund. One crucial question is whether the widespread support for the BEPS project in principle will continue when the project calls for coordinated action by these nations on specific issues.

Second, coordinated action by the member countries of the OECD, the BRICS, and developing countries is essential for the success of any action to combat aggressive tax planning by multinational enterprises, since multinationals operate and engage in tax planning on a worldwide basis. Unilateral action by countries, even countries with the largest economies, such as the US, is likely either to prove ineffective or to inflict serious damage on the domestic economy.

Third, the bad publicity generated by the attacks of politicians in Europe and the US against multinationals has generated a public perception that multinational corporations are engaged in tax avoidance activities that are probably illegal, and certainly immoral – multinationals appear to have been put on the defensive.

Fourth, the problems of BEPS – (incidentally, the terms "base erosion" and "profit shifting" are synonyms; they do not describe different problems) – are not new. International tax planning has been a standard part of business practice for decades, and inevitably, governments have responded with various types of rules to protect their tax bases. Therefore, it is important to see the current situation as just the most recent manifestation of the tension between multinational corporations and national tax authorities. In the past, however, tax authorities responded to international tax avoidance primarily with unilateral anti-avoidance measures in their domestic law or in their bilateral tax treaties. In contrast, multinational enterprises engage in tax planning on a worldwide basis.

As noted above, any effective response to the problem of international tax avoidance requires coordinated action by national tax authorities. It remains to be seen whether such coordinated action is feasible. On the one hand, the failure of the OECD's previous attempt to deal with harmful tax competition and the inability of countries to see beyond their narrow self-interest makes one skeptical about the BEPS project. On the other hand, the support of the G20 and the apparent success of the OECD-led efforts to improve exchange of tax information among all countries, including tax havens, suggests that the situation may be different today.

Finally, the BEPS project represents an opportunity to take some tentative first steps to redesign an international tax regime that has become a bit tired. Thus, the BEPS project should be viewed as simply the most recent and most ambitious episode in a long-term effort to make the international tax system less vulnerable to international tax planning by multinational enterprises. Even if only a few of the BEPS action items are successfully implemented, the effects will be significant.

The tax policy considerations underlying the OECD's BEPS initiative are superficially clear. Aggressive international tax avoidance by multinational enterprises has several harmful consequences for national tax systems:

(1) It reduces government tax revenues and increases the cost to governments of ensuring compliance by multinational enterprises with the tax rules.
(2) It undermines the perceived integrity of the tax system and may have a deleterious effect on tax compliance generally.
(3) It undermines the fairness of national tax systems because taxpayers other than multinational corporations must bear a greater share of the tax burden.
(4) Small- and medium-sized enterprises may not be able to take advantage of the same international tax planning opportunities as multinational enterprises and may therefore be placed at a competitive disadvantage.
(5) Finally, distortions in the location of investment may result to the extent that opportunities for aggressive tax planning are greater in the international context than in the domestic context.

However, the tax policy analysis of BEPS for any particular country is much more subtle and difficult than the foregoing list of consequences may suggest. The tax systems of many capital-exporting countries contain features designed to facilitate the international competitiveness of their resident multinational corporations. Over the past two or three decades, these countries have consistently taken domestic measures to enhance the competitive position of their resident multinational corporations, or at the least have avoided taking measures that would place their multinationals at a competitive disadvantage. Thus, many countries seem likely to have a two-faced attitude to BEPS. On the one hand, they want to protect their domestic tax bases from the aggressive tax-planning strategies of foreign-based multinationals. On the other hand, they have no interest in preventing their own resident multinationals from eroding the tax base of other countries (i.e., making them pay more foreign tax).

From any particular country's perspective, therefore, the ideal result from the BEPS project would be that other countries take action to require their multinational corporations to pay more foreign tax, while it does little or nothing with respect to its resident multinationals so that they gain a competitive advantage. In simple terms, this explains why coordinated action is so important and so difficult. Part of the difficulty relates to the widely varying interests of OECD member countries. For example, net capital-importing countries have different interests from net capital-exporting countries. In addition, some OECD members, such as Belgium, Ireland, Luxembourg, and the Netherlands, have significant interests both from a public perspective (tax revenue, investment, employment) and a private-sector perspective (professional firms and financial institutions) in facilitating international tax planning by multinational enterprises, and therefore have an interest in maintaining the status quo.

9.3 HYBRID ARRANGEMENTS

9.3.1 What Is a Hybrid Arrangement?

The term "hybrid arrangement" is generally used to describe situations in which two countries take different and inconsistent positions with respect to the tax treatment of some aspect of an arrangement. This inconsistent treatment may result in either beneficial or harmful consequences for a taxpayer. For example, inconsistent positions on transfer prices may result in double taxation, whereas inconsistent positions on the character of certain payments may result in a deduction in one country and no taxation in the other country. Of course, well-advised taxpayers, such as multinational corporations, will plan to avoid the harmful consequences of hybrid arrangements and use them to generate tax benefits.

Hybrid arrangements, as broadly defined above, include all the fundamental features of an income tax system: the persons subject to tax, the type of activities giving rise to income (employment, business, and investment), and the types of payments relevant for the computation of net income. However, the most important types of hybrid arrangements are hybrid entities and hybrid financial instruments.

Hybrid arrangements are often used as substitutes for tax planning arrangements involving tax haven entities. For example, tax haven entities are often used as intermediaries to receive deductible payments from an entity in a high-tax source country and then pay those amounts in a non-taxable form to a related entity in a high-tax residence country. A hybrid arrangement can achieve the same result without the use of a tax haven. For example, if an entity in a high-tax source country, HE (the hybrid entity) is treated as a flow-through or transparent entity, that country may treat deductible payments to HE as payments made to the owner of the entity, ACo, which might be resident in a high-tax country. The payments to HE might be exempt from source country tax, either under its domestic law or under the provisions of a tax treaty. The payments also might not be taxable by the residence country because it treats HE as a separate taxable entity. Therefore, as far as the residence country is concerned, the payments are not received by ACo.

9.3.2 Hybrid Entities

A hybrid entity is a legal relationship that is treated as a separate taxable entity in one jurisdiction and as a transparent or flow-through entity in another jurisdiction. For example, under the laws of Country A, it may be possible to establish a form of business organization in which the members own interests and have limited liability. Country A may treat this organization as a partnership for tax purposes, with the result that the members or partners are taxable on their shares of the income of the organization. On the other hand, under the tax laws of Country B, the organization may be characterized as a corporation – as a legal entity separate from its members or shareholders – with the result that the organization itself is subject to tax on its income. Accordingly, if one or more of the members of the organization is resident in Country B, the different treatment of the organization in the two countries creates many tax planning opportunities.

Hybrid entities may take many different shapes and forms. Whether or not a particular entity is a hybrid entity depends on the domestic laws of the countries involved and, in particular, how they characterize entities for tax purposes. For example, trusts and other similar fiduciary relationships may be hybrids because they are treated as entities by some common law countries but are ignored by some civil law countries. Hybrid entities may also include special entities or arrangements, such as corporations limited by guarantee, that are recognized under the laws of some tax havens. The "owners" of the value of the company (the guarantors) have rights and obligations pursuant to a contract, but have no rights to vote or receive dividends. The shares of the company are owned by shareholders who have the right to elect the directors but only limited rights to receive dividends. Dividends can be paid to persons who have no relationship with the company (i.e., persons related to the guarantor). The shareholders are typically trust companies that provide wealth management and estate planning services. Several tax havens have enacted legislation allowing the establishment of these types of entities, which have many of the characteristics of *inter vivos* trusts.

Several countries recognize silent partnerships, which are essentially contractual arrangements. The silent partners contribute assets to a managing partner in consideration for a share of the profits from a business. Silent partnerships are not treated as entities; the managing partner owns the assets transferred by the silent partners. The payments made to the silent partners are usually deductible in computing the income of the managing partner, although they may be subject to withholding tax. If the country in which a silent partner is resident treats the silent partnership as a partnership, and if it taxes business income on a territorial basis, then there will be no tax, except possibly withholding tax, in either country.

In a 1998 case in the United Kingdom, *Memec PLC v. IRC* [1998] STC 754 (Court of Appeal), Memec, a UK company, owned shares of a German company, which in turn owned shares of two German operating companies. The operating companies paid German trade taxes that were not creditable against UK tax when Memec received dividends from its top-tier German subsidiary. Therefore, Memec entered into a silent partnership with the German corporation and then claimed that it had received dividends as a partner directly from the operating companies, so that the trade taxes were creditable. The UK Court of Appeal held that the German silent partnership was not a partnership under UK law and that the source of the income was the contractual arrangements.

In the last fifteen to twenty years, tax planning opportunities through the use of hybrid entities have proliferated as a result of the US **check-the-box rules**. Before 1997, entities were classified as corporations or partnerships under US tax law based on six factors, including limited liability, continuity of life, centralized management, and free transferability of interests; tax planners were able to manipulate these factors to achieve the desired status for an entity. For example, the use of limited liability companies (LLCs) as transparent investment vehicles became very popular. LLCs were created under special state statutes as vehicles for tax shelters, providing limited liability for investors but treated as transparent for US tax purposes.

In 1997, the US government adopted check-the-box rules, which made the classification of many business entities elective for taxpayers. Instead of manipulating the six factors to achieve the desired characterization, taxpayers can simply elect to have an entity treated as a corporation, a partnership, or a disregarded entity (if the entity has only one member) by checking a box on a prescribed form. A disregarded entity is treated as a sole proprietorship if the single owner is an individual, or as a branch if the single owner is a corporation. The election can be made with respect to LLCs, partnerships, joint ventures, branches, and other business entities, and it can be made with respect to entities created under foreign laws. Once made, an election cannot be altered for five years. The election cannot be made for certain entities that are clearly corporations (so-called per se corporations).

The US check-the-box rules were motivated by a desire to simplify domestic tax planning and administration. Perhaps inadvertently, they also made the use of hybrid entities for investment into and out of the US much more attractive and certain. For example, a double-dip financing arrangement for the acquisition or expansion of a US business might be structured in the following way.