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# Taxation of Residents on Foreign Source Income

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# Taxation of Residents on Foreign Source Income

*Peter Harris*

The prescriptive rules in tax treaties for taxation of foreign source income in the residence country are more limited than those that apply to restrict source country taxing rights. This is despite the fact that the acknowledged purposes of tax treaties (elimination of double taxation and prevention of fiscal evasion) have equal relevance for both source and residence countries. The comparative lack of prescriptive rules has an important impact on the manner in which the taxation of foreign source income is administered in residence countries, with heavy reliance on domestic tax rules.

The first matter this paper looks at is the manners in which tax treaties can impact the administration of taxation in the residence country. The primary impact is an obligation to eliminate double taxation of foreign source income of residents and a number of provisions of tax treaties may be relevant in this regard. Often less obvious is the subtle manner in which tax treaties interact with anti-abuse rules, whether the anti-abuse rules are of a specific or general nature. Having identified the relevant provisions in tax treaties and their potential scope, the paper moves to consider in turn the administrative mechanics of these two issues, i.e. elimination of double taxation with respect to and application of anti-abuse rules to foreign source income. The final heading considers the effect of deriving foreign source income on general tax administration issues, with a particular focus on collection of information, proof of foreign income and foreign tax and time limits.

## 1. Impact of tax treaties and elimination of double taxation

Both the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] ("UN Model Convention") and the Organization for Economic Co-operation and Development's Model Tax Convention on Income and on Capital[2] ("OECD Model Convention") recognize the dual main purposes of tax treaties as the elimination of double taxation and the prevention of fiscal evasion.[3] Both these purposes of tax treaties are important in the taxation of

[1] United Nations, Department of Economic and Social Affairs, *Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[2] Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010) (loose-leaf).

[3] OECD Model Convention, Title of Convention, footnote 1 and UN Model Convention, Title of Convention, footnote 1. And see, for example, paragraphs 3 and 16 of the Introduction to the OECD Model Convention; paragraph 12 of the Commentary on Article 10 of the OECD Model Convention,

foreign source income of residents. The manner in which these purposes may impact on such taxation requires an understanding of who are residents and when income is considered as having a foreign source. The first of these is critical in the application of tax treaties. As a general rule, tax treaties only apply to "persons" (as defined) who are "residents" of a contracting state (Article 1).[4] That application, entitlement to treaty benefits and the definition of "resident" (Article 4) are discussed in a separate paper[5] and are not further explored here.

## 1.1 Source of income must be determined by general principles

As for the source of income, generally tax treaties do not contain many express source rules. Rather, they grant taxing rights to certain countries on the bases specified in the various articles of the tax treaty and, in particular, the distributive rules in Articles 6 through 21. In most cases, though not all, an express taxing right of the residence country is referred to.

These distributive rules of tax treaties also grant taxing rights to the contracting state that is not the residence country, for the purposes of this paper referred to as the "source country". While it is, perhaps, accurate to say that when a treaty grants a source country a right to tax, the source of the income is located in that country, it is not accurate to suggest that the right of a source country to tax under tax treaties represents a comprehensive set of rules for determining the source of income. Consistent with the purpose of tax treaties in eliminating double taxation and as a mechanism for allocating taxing rights between countries, tax treaties limit the rights of source countries to tax income that may, according to general principles, be considered to be sourced in that country. So there are many circumstances in which income may be considered to have a source in a particular country, but that country is not granted a taxing right under tax treaties.

Consequently, for the purposes of this paper, "foreign source income" with respect to a country is taken to mean income that according to general principles does not have a source in that country. Foreign source income includes, but is not limited to income that may be taxed under a treaty by a treaty partner on a basis other than residence of the person deriving the income. Further, "foreign source income" may be, according to general principles, considered sourced in a treaty partner or

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reproduced in paragraph 13 of the Commentary on Article 10 of the UN Model Convention. However, paragraph 3 of the Introduction to the OECD Model Convention still suggests that "the main purpose of the OECD Model" is to settle "problems that arise in the field of international juridical double taxation."

4 Unless specified otherwise, references to Articles in this paper are references to the Articles of the UN and OECD Model Conventions.

5 See Joanna Wheeler, Persons Qualifying for Treaty Benefits, Paper 2-A of this collection.

sourced in some third country. In the latter case it is referred to as "third country income". None of this discussion is intended to suggest that there is general agreement on how to locate source according to general principles, but that is not something regulated by tax treaties. It is, however, something that must be regulated by domestic law, discussed further below.

### 1.2 Tax treaties do not limit the scope of residence country's right to tax foreign income

While tax treaties limit source country taxing rights, a more difficult question is whether the distributive provisions of tax treaties represent any restriction on a residence country's right to tax. The better view seems to be that the distributive rules in Articles 6 to 21 are not intended to directly limit residence country taxing rights,[6] although as discussed below this may happen indirectly and particularly under other provisions of tax treaties. It seems that any reference to residence country taxing rights in the distributive rules of tax treaties is often used as a method of limiting source country taxing rights. This is particularly the case where the distributive rules say that certain income "shall be taxable only" in the residence country, with specific exceptions where the source country is granted a right to tax.[7]

Less clear is whether the reference to residence country taxing rights in the cases of Articles 10 (dividends), 11 (interest) and 12 (royalties, UN Model Convention only) may be considered simply as a mechanism for limiting source country taxing rights. These provisions say that the residence country "may" tax and go on to symmetrically refer to situations when the source country "may also" tax. A difficulty is in determining the scope of these provisions because they only refer to dividends, interest or royalties "paid" by a resident of a contracting state to a resident of the other contracting state.[8] It is generally accepted that these rules do not limit a residence country's right to tax

[6] Article 19 (government service) of both the UN and OECD Model Conventions is an exception. This provision is intended to directly limit residence country taxing rights.

[7] For example, this is the approach in Articles 7 (business profits), 8 (shipping, although using a proxy test of residence), 12 (royalties, OECD but not UN Model Convention), 13 (capital gains), 14 (independent personal services, UN version), 15 (dependent services), 18 (pensions), 19 (government service) and 21 (other income). Analysis of Article 20 (students), which specifies a contracting state in which certain income "shall not be taxed", is more complex. See also paragraph 6 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the UN Model Convention.

[8] Articles 11(5) (of both the UN and OECD Model Conventions) and 12(5) (UN Model Convention only) extend the scope of the articles on interest and royalties to interest and royalties "borne" by a permanent establishment or fixed base (UN Model Convention only) in one contracting state and "paid" to a resident of the other contracting state. Under these extending source rules, the residence of the "payer" is irrelevant.

dividends, interest and royalties either when paid or in other circumstances, e.g. as they accrue or deemed payments of this type. By contrast, it is generally (although not universally) accepted that these rules *do* limit source country taxing rights, i.e. the source country may tax only when these items are "paid".

Part of the problem is that the scope of Articles 10, 11 and 12 is not specified. If the reference to "paid" and the "payer" being a resident of a contracting state determines the scope of the provisions, then those provisions would not deal with any other amounts that may be described as dividends, interest or royalties. These other amounts would fall residually into Article 21 (other income) or, perhaps, Article 13 (capital gains). Under the OECD Model Convention, this would mean that, as a general rule, the income would be "taxable only" in the residence country. By contrast, if the income falls under Article 21 of the UN Model Convention, the source country (country in which the income "arises") is granted an unlimited right to tax.[9] In any case, the better view is that Articles 10, 11 and 12 do not limit a residence country's right to tax.

The same also seems true of other distributive rules that do not refer to a residence country's right to tax. Articles 6 (immovable property), 16 (directors' fees) and 17 (artistes and sportsmen) grant no express right to tax to residence countries. However, they also impose no limitation on the right of residence countries to tax and it is accepted that the residence country's inherent right to tax income covered by these articles is not affected. Indeed, the residence country's obligation to eliminate double taxation (Article 23) presumes that the residence country has a right to tax any income that may be taxed by the source country. The distributive rules of tax treaties do not force a source country to tax even if the source country has an unlimited right to tax. Similarly, such rules do not require that a residence country impose tax on foreign source income of its residents. The general principle that tax treaties do not impose tax applies equally to residence countries as it does to source countries.

### 1.3 Tax treaty limitations on the manner in which residence country taxes

While tax treaties may not prevent a residence country from taxing foreign source income of its residents, they do impose other obligations as to the manner in which that tax may be imposed. Tax treaties contain many rules that affect the manner in which source countries calculate income and the tax rate that they may impose on the income. This is not true of residence countries, where there are

[9] This is by reason of Article 21(3) of the UN Model Convention. This unlimited right to tax can be contrasted with the limited right of the source country to tax under Articles 10, 11 and 12.

few rules relating to the manner in which foreign source income should be calculated and the rate of tax that may be imposed with respect to that income. After those rules are considered, the discussion turns to the main tax treaty obligation imposed on residence countries - the obligation to eliminate double taxation.

### 1.3.1 Non-discrimination

The non-discrimination rules in tax treaties (Article 24) contain important (though not comprehensive) limitations on the taxing rights of contracting states. While these rules are, perhaps, primarily targeted at source countries or countries hosting foreign investment, there are cases in which they can apply to residence countries. In particular, if the resident person in question is a national of the other contracting state, the residence country cannot subject that person to more burdensome taxation than its own nationals who are also resident.[10] Similarly, a residence country cannot subject a resident entity conducting a business to more burdensome taxation by reason that the entity is owned or controlled by residents of the other contracting state.[11] While this provision has important application where income is sourced in the residence country, it can also apply to the taxation of foreign source income (including third country income) and, in particular, the application of unilateral foreign tax relief (discussed below).

By contrast, Article 24(4) prevents a residence country from denying a resident a deduction for "interest, royalties and other disbursements" paid to a resident of the other contracting state if a deduction would be available were the amount paid to a resident of the residence country. This rule is not targeted at the calculation of foreign source income, but can have application in that context. It has no application except with respect to deductibility of amounts and so does not apply to tax rates or tax reliefs such as tax credits.

While these provisions prevent discrimination in the taxation of foreign source income based on nationality, ownership, control or recipient of payment, they do not prevent discrimination in the taxation of foreign source income per se. So, for example, provided those rules are not engaged, a residence country is at liberty to impose more tax on foreign source income than on equivalent domestic source income, whether that be by reason of tax rates or the availability of deductions or reliefs. Tax treaties simply do not engage with this sort of discrimination. Similarly, tax treaties do not expressly prevent more or less taxation by a residence country of income derived by its residents

[10] Article 24(1) of both the UN and OECD Model Conventions.

[11] Article 24(5) of both the UN and OECD Model Conventions.

from some foreign countries (including tax treaty partners) when compared to income derived from other foreign countries (no most favoured nation requirement).[12]

### 1.3.2 Corresponding adjustments

Residence country taxation may also be affected by the obligation to make corresponding adjustments under tax treaties. This occurs where the other contracting state makes a transfer pricing adjustment (primary adjustment) in accordance with Article 9(1) (associated enterprises) or a specific allocation of profits to a permanent establishment (hereafter "PE") under Article 7(2). Articles 7(3) (OECD Model Convention only) and 9(2) may require the residence country to adjust the taxation of the associated enterprise or holder of the PE resident in that country in order to avoid double taxation.[13] Conceptually, the corresponding adjustment rules are primarily targeted at the allocation of source of income between countries. However, they are not limited in that regard and in an appropriate case can be applied to residence country taxation of foreign source income.

### 1.3.3 Elimination of double taxation

The primary manner in which residence country taxation of foreign source income is affected by tax treaties is the obligation to eliminate double taxation of income that has already been taxed in the source country (Article 23). There are two alternative versions of Article 23 - the exemption method (Article 23A) and the credit method (Article 23B). Details of the manner in which these provisions are to be administered in the residence country are discussed below. At this stage, it is important to identify some limitations as to the scope of the obligation in Article 23 and then the discussion moves on to consider how countries respond to those limitations.

Article 23 (whether Article 23A or 23B) obliges the residence country to eliminate double taxation of income of a resident that "in accordance with" the tax treaty "may be taxed" in the other contracting state. In this context, it is irrelevant whether the income can be correctly described as sourced in the other contracting state. The issue is simply whether according to the distributive rules of the tax treaty the other contracting state has a right to tax or not. The OECD (though not the UN)

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12 In this context, most favoured nation treatment would require the residence country to tax income derived from a particular foreign country no less favourably than income derived from any other foreign country. Alternately, national treatment in this context would require that income derived from a particular foreign country be taxed no less favourably than income derived from the residence country itself.

13 Some countries take the view that the mutual agreement procedure (discussed below at 4.3) can produce a similar result; for example, see paragraph 2 of the Commentary on Article 25 of the UN Model Convention.

confirms that whether the other contracting state has a right to tax or not is to be determined by that other contracting state applying the tax treaty to its own law.[14] The right to tax (and so the residence country's obligation to provide relief) is not tested by asking whether the other contracting state would have a right to tax if residence country law were applied. So if the residence country tax administration wishes to question the source country's right to tax (and so the residence country's obligation to provide relief) it must engage in the difficult task of applying the tax treaty to the law of a foreign country, i.e. the law of the source country. This does not mean that a residence country must agree with the source country as to the facts of a particular case or the proper application of a treaty.[15]

This approach in Article 23 means that elimination of double taxation by a residence country under a tax treaty is often narrower, and can be substantially narrower, than under unilateral relief rules.[16] First, where the source country has no right to tax under a tax treaty, the residence country has a full right to tax (in which case relief from double taxation is effectively provided by the source country). Second, the obligation to provide relief only extends to source country taxes covered by the treaty. These are outlined in Article 2 and under model treaties extend to "substantially similar taxes" to those mentioned in the tax treaty. Any taxes that are not so similar and, where that extension is not present in a treaty, taxes not mentioned in the treaty do not fall within the residence country's obligation to eliminate double taxation. Third, it is usual for tax treaties to only cover taxes imposed by the contracting states and sometimes this does not extend to income taxes imposed by lower tiers of government, especially where the source country is a federal country.[17]

Finally, Article 23 only covers juridical double taxation (taxation of the same person with respect to the same income) and not economic double taxation (taxation of different persons with respect to the same income).[18] The major example of economic double taxation is the taxation of a corporation

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[14] Paragraphs 32.1-32.4 of the Commentary on Article 23 of the OECD Model Convention. And see the discussion in Harris & Oliver (2010), note 1, pp. 277-8.

[15] As to which, see paragraph 19 of the Commentary on Article 23 of the UN Model Convention.

[16] Most major capital exporting countries provide some form of unilateral foreign tax relief. Typically, this means that a country will provide a foreign tax credit or exemption with respect to foreign source income of its residents irrespective of whether a treaty is in place and, in most cases, irrespective of whether the source country provides reciprocal relief.

[17] Article 2(1) of both the UN and OECD Model Conventions does cover taxes imposed by "a Contracting State or its political subdivisions or local authorities", but this prescription is not always followed in practice.

[18] For example, see paragraphs 1 and 2 of the Commentary on Article 23, of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the UN Model Convention.

with respect to its profits when derived and the taxation of distributions of those profits in the hands of the corporation's shareholders without relief for one tax against the other. For example, when a foreign subsidiary distributes a dividend to a local parent corporation, tax treaties presume that the source or host country will tax the profits of the subsidiary and impose at least a limited withholding tax on distributions to the parent. In addition, tax treaties presume that the residence country of the parent will tax the distribution in full and only eliminate juridical double taxation by providing a foreign tax credit for any withholding tax imposed. If capital exporting countries adopted this approach, it would place a substantial limitation in the way of cross-border direct investment and a great incentive for any such investment to be structured in a way to erode the source / host country corporation tax base of the subsidiary, e.g. by ensuring deductible payments are made to the parent rather than non-deductible dividends.[19]

In passing, it may be noted that model tax treaties do provide for the elimination of some forms of economic double taxation, although not in Article 23. In particular, where a contracting state (e.g. the source country) makes a transfer pricing adjustment under Article 9(1) with respect to one party to a transaction, full taxation by the other contracting state of the other party to the transaction may result in a form of economic double taxation. A similar form of double taxation can arise in the context of an adjustment to the allocation of profits to a PE under Article 7(2). In this context, the obligation on the other contracting state to make a corresponding adjustment to the profits of the other party under Article 9(2) (or, in the context of a PE, Article 7(3) of the OECD Model Convention only) can be viewed as a form of relief from double taxation. Further, Article 25(3) provides that the competent authorities of the contracting states may consult for elimination of double taxation not covered by the tax treaty. There is no obligation to reach agreement in this regard and in practice this provision is rarely used and is not used as a general mechanism to provide relief from economic double taxation of corporate income.

These limitations as to the scope of Article 23 mean that often it is not followed precisely in tax treaties. In the vast majority of tax treaties the distributive rules apply equally to both contracting states. This is not true of Article 23. It is standard practice for tax treaties to split Article 23 into a part providing for the elimination of double taxation by one contracting state and another part providing for the elimination of double taxation by the other contracting state.[20] In doing so, many

[19] See paragraphs 49 to 52 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the UN Model Convention.

[20] See paragraph 30 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the UN Model Convention.

countries will also make provision for relief of economic double taxation of corporate income where a subsidiary in the other contracting state distributes a dividend to a parent corporation resident in the subject country. By contrast, it is rare (and increasingly so) for tax treaties to provide for relief from economic double taxation of corporate income derived by portfolio shareholders (e.g. individuals and non-substantial corporate shareholders) through a corporation. Any such relief for portfolio shareholders is usually provided unilaterally in the domestic law of the residence country.

As mentioned, the obligation to provide tax treaty relief for the elimination of juridical double taxation typically depends on whether the source country has a right to tax when applying the tax treaty to that country's tax law. Most commonly, treaty provisions for relief from economic double taxation (where they exist) do not follow this approach. For example, the application of such provisions is not dependent on the distribution in question falling within the definition of "dividend" in Article 10, as applied by the source country. In providing relief from economic double taxation, often there is a separate reference to "dividend" in the Article on elimination of double taxation, which does not draw its meaning from Article 10. Rather, the meaning of any reference to "dividend" in the Article on elimination of double taxation (absent any express definition) will be determined by the residence country applying the tax treaty to its own law, and Article 3(2) of the treaty may be relevant in this regard.

Another general limitation on the application of Article 23 as found in model tax treaties is that it is relatively brief and so does not elaborate on many of the details that are often necessary in applying the provision in practice. Other provisions in tax treaties that suffer from brevity are often supplemented with extensive commentary or guidelines, but that is not the case with Article 23. As a result, residence countries often need to create domestic rules (statutory or otherwise) detailing the manner in which double taxation is to be eliminated under its tax treaties.[21] For this reason, it is common for the part of the Article on the elimination of double taxation that applies to a particular contracting state to refer to the provisions of that state's domestic law that eliminate double taxation. These domestic law rules may apply only to tax treaties, but more often they form the basis of unilateral foreign tax relief granted by that country, a matter to which the discussion now turns.

## 1.4 Unilateral foreign tax relief

[21] See paragraphs 38 and 60 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the UN Model Convention.

The vast majority of developed countries and many developing countries unilaterally in their domestic law provide relief from double taxation of foreign source income of residents. Unilateral relief often (though not always) reduces the impact and significance of the obligation to provide elimination of double taxation under tax treaties. This may happen for a number of reasons. First, as mentioned, the elimination of double taxation Article in many tax treaties refers to and is limited by the scope of the domestic law rules. Second, there are instances where the method of foreign tax relief offered unilaterally is more generous than that offered under a tax treaty, in which case the taxpayer is typically entitled to insist on the unilateral relief. This particularly happens where a country's tax treaties incorporate the foreign tax credit method and the country later unilaterally implements the exemption method. Third, the scope of the unilateral relief may be broader than that available under tax treaties, such as where unilateral relief incorporates relief from economic double taxation of corporate income but tax treaties do not or where unilateral relief extends to taxes not covered by tax treaty relief (e.g. excess profits taxes or state or local government income taxes, if these are not covered by a treaty).

Unilateral foreign tax relief rules are substantially different as to their structural features when compared with tax treaty rules. In particular, they are not confined by reference to a treaty; rather domestic law of the residence country will rule all aspects of scope of the relief. So, in applying unilateral rules a residence country must identify what is *foreign source income* for which relief is available and how that income is to be calculated (including the allocation of expenses). Unilateral rules must identify when foreign taxes are sufficiently similar to domestic taxes to qualify for relief. Unilateral rules also usually provide for a nexus between the foreign tax and the foreign income in order to qualify for relief, e.g. the foreign income must (according to the rules of the residence country) be seen to have a source in the foreign jurisdiction that imposes the foreign tax.

## 2. Administering the mechanics of elimination of double taxation

Effective administration of the mechanics of elimination of double taxation requires an understanding of the accepted rationale for such relief. It is widely accepted that the obligation on the residence country to eliminate double taxation of foreign source income is consistent with the principle that the source country has the first right to tax (*source country entitlement principle*). This principle suggests that where a source country exercises a legitimate right to tax the residence country should not tax in such a manner as would result in double taxation. Relief from double taxation of cross-border income is consistent with a global view of allocating resources efficiently. As Article 23 illustrates, the main methods for elimination of double taxation are the exemption and foreign tax credit methods.[22]

The following discussion considers the main features in administering first the exemption method for elimination of double taxation and then the credit method. Each of these methods raises issues as to how expenses should be allocated between the foreign source income in question and other income of the person deriving the income (whether domestic source income or other foreign source income). The allocation of expenses can have a dramatic effect on the quantum of relief available and yet is subject to few, if any, rules in tax treaties. This is the third matter considered in the following discussion. Finally, the discussion turns to the mechanics of the elimination of economic double taxation of corporate income on distribution, i.e. the taxation of foreign source dividends, whether that relief is provided unilaterally or by tax treaty.

## 2.1 Exemption method

The exemption method is conceptually simple. It suggests that if income has been appropriately taxed in the source country then the residence country should eliminate the potential for double taxation by exempting the foreign source income. The mechanics of administering an exemption system are not so simple, particularly if the residence country wants to ensure that the system is not open to abuse. If there is a lack of taxation in the source country, then the residence country providing an exemption for foreign source income means the income is not taxed at all. This can distort an efficient allocation of resources and defeat the rationale for the residence country providing relief.

For this reason, tax treaties typically limit the exemption method to income that may be fully taxed in the source country, such as income from land, business (PE), professional services and employment. However, Article 23A(1) does not require that the source country actually tax. The fact that the source country "may" tax is sufficient to oblige the residence country to exempt the foreign source income. This can be particularly problematic where the residence country has assessed (sometimes incorrectly, because it references its own tax law) that the source country may tax, but the source country does not agree or intentionally does not tax. A good example of this is where the source and residence countries do not agree as to the scope of what is and what is not a PE (giving

[22] It is conceptually possible for a residence country to reduce the rate of tax on foreign source income, but this is rare.

rise to a full source country taxing right under Article 7).[23] The situation can also be complicated if the residence country unilaterally offers an exemption and the scope of that exemption is broader than the source country's right to tax under a tax treaty with the residence country.

As a result, some countries in their tax treaties and unilaterally require that the source country actually subject the income to tax before the residence country exemption is available.[24] While a potentially important limitation on the provision of an exemption, *subject to tax* clauses raise difficult administrative issues as to precisely what constitutes the source country subjecting foreign source income to tax. There may be issues as to the type of foreign tax that qualifies, whether the quantum of foreign tax is relevant and whether the taxpayer can elect to pay the tax in an effort to qualify for the exemption in the residence country.

Consistent with ensuring that income is fully taxed, the exemption method under tax treaties usually does not apply to income that may be taxed only partly by the source country. This is particularly the case where payments such as dividends, interest, royalties and even service fees may be subjected to a limited withholding tax in the source country. In these types of cases, tax treaties usually switch to the foreign tax credit method, a switch that is recognised in Article 23A(2).

Even where an exemption is available, there are numerous reasons why the residence country is likely to require the taxpayer to declare the exempt foreign income in their annual tax return. One reason is simply to check that the foreign income has been properly calculated (including the appropriate allocation of expenses) and the exemption properly claimed. If a subject to tax clause applies, the taxpayer may be required to provide proof of the payment of the foreign tax. Declaration of foreign source income may be necessary for other reasons, especially where deriving exempt foreign source income impacts on the taxation of other income or the availability of certain government benefits such as social security payments.

A number of countries adopt *exemption with progression* and application of this variation of the exemption method is recognized by Article 23A(3). Exemption with progression is only relevant where the taxpayer is subject to progressive tax rates. It means that exempt foreign source income may *occupy* lower tax brackets and push other income (domestic or foreign source) into higher tax brackets. There are different ways of applying exemption with progression and the details are usually

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[23] For a response to this type of issue, see paragraph 19 of the Commentary on Article 23 of the UN Model Convention.

[24] See paragraph 35 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the UN Model Convention.

provided by domestic law of the residence country. The whole of the exempt foreign source income may take up the lower tax brackets or perhaps only the proportion that the exempt foreign source income is of the taxpayer's total income.

**Box 1**
**Exemption with Progression for Foreign Income**

A resident derives 100 foreign source income and 100 domestic source income. The foreign income is taxed in the source country at the rate of 30%. The residence country eliminates double taxation in the form of exemption with progression where foreign source income forms the lowest taxed slice of income. The residence country taxes at progressive rates of 20% on the first 100 of income and 40% on the rest.

| | |
|---|---|
| Foreign Source Income | 100 |
| Source Tax @ 30% | 30 |
| | ----- |
| Income Net of foreign tax | 70 |
| Residence Exemption | - |
| | ---- |
| Net Return | 70 |
| Domestic Income | 100 |
| Domestic Tax | |
| 20% first 100 (all foreign) | - |
| 40% rest (all domestic) | 40 |
| | --- |
| Net Return | 60 |

If the residence country had adopted a top slicing rule where the foreign source income was taxed at the highest rates then the residence country tax liability on the domestic source income would have been 20.

Exempt foreign source income may also have an impact on other residence country tax attributes of the person deriving the income. The most obvious example is the use of tax losses. Most countries allow losses, especially from business activities, to reduce income from other activities or be carried forward. Where losses are available, a question is whether those losses are to be reduced by exempt foreign source income, which would mean that the losses are not available to reduce other, taxable income. This is a matter that is not regulated by tax treaties. As such, it is a matter for domestic law. Again, there are different styles of rule that may be applied in this regard, from no requirement to use the losses against exempt foreign source income to a requirement to first fully reduce any losses by exempt foreign source income. It is also possible to use apportionment rules and have a different treatment depending on whether the loss is from a foreign or domestic source.

**Box 2**
**Exempt Foreign Income and Domestic Losses**

A resident has a carried forward loss of 100 from domestic activities. In the current year the resident derives 100 foreign source income and has 100 domestic source income. The foreign income is taxed in the source country at the rate of 20%. The residence country eliminates double taxation in the form of exemption of the foreign source income. Nevertheless, the domestic law requires the resident to use the carried forward loss proportionately against the foreign income (before foreign tax) and the domestic income. The residence country taxes at the rate of 30%.

| | |
|---|---|
| Foreign Source Income | 100 |
| Source Tax @ 20% | 20 |
| | ----- |
| Income Net of foreign tax | 80 |
| Residence Exemption | - |
| | ---- |
| Net Return | 80 |

Carried forward loss is set against foreign income proportionately. Foreign income reduces the loss by 50. 50 remains available to set against the domestic income.

| | |
|---|---|
| Domestic Income | 100 |
| Less remaining loss | (50) |
| Taxable Income | 50 |
| Residence Tax @ 30% | 15 |
| | --- |
| Net Return | 85 |

If the residence country required the carried forward loss to be fully set against any foreign source income, the foreign source income would have exhausted the loss. In this case the residence country tax on the domestic income would have been 30.

## 2.2 Credit method

The foreign tax credit method is the other main method by which residence countries eliminate double taxation of foreign source income and, as discussed with respect to the exemption method, is typically at least the residual method. This method is explicitly provided for in Article 23B of model tax treaties, although this provision is brief and does not contain many of the details required for the operation and administration of a foreign tax credit system. As discussed, these details are typically provided by domestic law, often in the context of unilateral relief. It is fair to suggest that, so far as the rules in Article 23B are concerned, those rules facilitate rather than limit the choices available to a residence country in implementing a foreign tax credit system.

The foreign tax credit system eliminates double taxation by reducing residence country tax due with respect to foreign source income by any tax imposed on that income by the source country. All foreign tax credit systems must deal with the possibility that the source country tax exceeds the residence country tax and so may give rise to what is commonly referred to as *excess foreign tax credits*. Virtually all foreign tax credit systems incorporate a *limitation on credit*, which operates so that excess foreign tax credits are non-refundable and cannot be set against tax due with respect to domestic source income (sometimes called an *ordinary credit*). This limitation is expressly accepted in Article 23, although that provision does not contain details as to how the limitation on credit should be calculated.

**Box 3**
**Limitation on Credit — Excess Foreign Tax Credits**

A resident derives 100 foreign source income. The foreign income is taxed in the source country at the rate of 40%. The residence country eliminates double taxation in the form of a foreign tax credit. The residence country taxes at the rate of 30%.

| | |
|---|---|
| Foreign Income | 100 |
| Source Tax @ 40% | 40 |
| | ----- |
| Income Net of Foreign Tax | 60 |
| Gross-up by Residence Country | 40 |
| | ---- |
| Taxable Income | 100 |
| Residence Tax @ 30% | 30 |
| Less Foreign Tax Credit (limited to residence tax) | 30 |
| | ---- |
| Net Residence Tax | 0 |
| | ---- |
| Net Return | 60 |

Even though the foreign tax is 40, the foreign tax credit available in the residence country is limited to the residence country tax on the foreign source income. So a credit is available only for 30. Some countries permit the excess foreign tax of 10 to be used against residence country tax on other foreign source income or to be carried forward or back for use in other tax years.

Under the domestic laws of a number of countries, the credit is simply limited to the amount of domestic tax due with respect to foreign source income. Such an approach does not permit excess relief. Other countries do take into account the amount by which foreign tax may exceed domestic tax, e.g. by recognizing excess foreign tax credits and permitting these to be carried forward for use in future years.

**Box 4**
**Limitation on Credit — Country-by-Country Approach**

A resident of Country B derives 100 business profits from Country A and 100 interest from Country A. The tax rate on business profits in Country A is 30% and Country A imposes a final withholding tax of 10% on interest paid to non-residents. Country B taxes the resident at 20%.

Country A Tax

| | |
|---|---|
| Business Income | 100 |
| Source Tax @ 30% | 30 |
| Interest Income | 100 |
| Source Tax @10% | 10 |
| | ----- |
| Income Net of Foreign Tax | 160 |

Country B Tax

| | |
|---|---|
| Gross-up (30 + 10) | 40 |
| | ---- |
| Taxable Income | 200 |
| Residence Tax @ 20% | 40 |
| Less Foreign Tax Credit (limited to residence tax) | 40 |
| | ---- |
| Net Residence Tax | 0 |
| | ---- |
| Net Return | 160 |

If separate calculations were required for calculation of the foreign tax credit for the business income and the interest income (i.e. an item-by-item approach) then the credit for source tax on the business profits would have been limited to 20, i.e. the residence country tax on those profits. There would have been excess foreign tax of 10 (30 - 20) for which no foreign tax credit would be available due to the limitation on credit. Further, there would have been 10 Country B tax payable with respect to the interest income because the Country B tax on this income exceeds the source tax by this amount. By using the country-by-country approach to the limitation on credit, Country B permits the excess source tax on the business profits to reduce residual Country B tax on the interest income.

Irrespective of whether excess foreign tax credits may be carried forward or back, foreign tax credit systems must incorporate rules as to the scope of calculating the limitation on credit. Article 23 permits a country to calculate the limitation on credit separately for each item of income. So, for example, foreign tax paid with respect to the profits of each PE, income from each piece of immovable property, each dividend, interest or royalty etc. would be tested against the residence country tax payable on that item of income to determine the limit of the credit available. This is often referred to as an *item-by-item*, *source-by-source* or *slice-by-slice* approach to calculating the limitation on credit. It can result in numerous calculations by a person deriving foreign source income from a particular treaty country. It can also mean that foreign tax that exceeds residence country tax on one item of foreign source income cannot be used to reduce residence country tax that exceeds foreign tax on another item of foreign source income, depending on how excess foreign tax credits may be used.

Some countries opt to simplify the item-by-item approach by amalgamating different items of foreign source income in some fashion for purposes of reducing the number of times the limitation on credit has to be calculated. There are a number of ways to achieve this reduction, the main difference between each type being the extent of averaging of foreign tax that is permitted. One obvious choice is to calculate the limitation by reference to foreign tax payable on all income derived by a person from a particular country, i.e. a *country-by-country* limitation. This can be consistent with the bilateral nature of tax treaties, but some countries amalgamate income from numerous countries when calculating the limitation on credit. This is more likely to happen under unilateral relief.

The amalgamation may simply be all of a person's foreign source income from wherever derived. The total foreign tax paid with respect to that global amount of foreign source income is then compared to the amount of domestic tax attributable to that amount. This is referred to as a *worldwide* limitation on credit. Countries may also require a separate limitation on credit calculation for particular types of foreign source income, e.g. all business profits, all income from immovable property, all passive income, all capital gains etc. This is often referred to as a *type of income* or *basket* limitation on credit, in which case the particular country from which the income is derived may be irrelevant. The worldwide and type of income approaches to the limitation on credit may be designed in such a way as to be consistent with the manner in which income is required to be calculated under domestic law, e.g. according to a global or schedular approach (discussed below).

Foreign tax credit systems also give rise to issues as to the manner in which a residence country taxes foreign source income. This was touched on above at 1.3.1 in the context of the discussion of non-discrimination. Questions arise as to what expenses are deductible, if any, in calculating foreign source income and this can have a dramatic effect on calculating the limitation on credit. Deductions are discussed below at 2.3. Further issues arise as to the rate at which a residence country taxes foreign source income. Some countries apply special tax rates to particular types of income, e.g. dividends and capital gains are often subject to lower tax rates than other types of income. One question is whether these lower rates apply to foreign source income of the relevant type. While tax treaties do not typically deal with such issues, Article 23 requires a foreign tax credit to be granted irrespective of the domestic tax rate on the foreign source income. Similar issues arise as to whether and in which manner particular reliefs (such as foreign source losses and allowances and tax credits available for things such as research and development) are available with respect to foreign source income.

The taxation of foreign source income by a residence country at non-uniform rates can also impact on the manner in which the limitation on credit is calculated. This is also the case where an exemption is available with respect to some types of foreign source income, but a foreign tax credit is available with respect to other types. The issues are similar to those discussed above at 2.1 in the context of exemption with progression. In the context of progressive rates, the issue is whether foreign source income, for which foreign tax credits are available *occupy* lower tax brackets (*bottom slicing*), are treated as occupying proportionately all tax brackets or are treated as income subject to highest tax rates (*top-slicing*). Bottom slicing increases the likelihood that the limitation on credit will be engaged.

With the exemption method, only one slicing rule is required in applying exemption with progression (see Box 1 above). If the limitation on credit under a foreign tax credit system is calculated in any manner other than a worldwide limit, then the system will require multiple slicing rules to match the number of times the limitation on credit may be calculated. For example, if a country-by-country limitation is adopted (see Box 4 above), the tax law must specify whether income derived from one country is the bottom slice or whether the income derived from another country is the bottom slice. This is important because the levels of foreign tax will vary for each calculation and it really matters to the total residence country tax liability the order in which the country taxes foreign source income. If a residence country exempts some types of foreign source income, e.g. by adopting Article 23A, then again the residence country must specify whether the exempt foreign income occupies lower tax brackets when compared with foreign income for which a foreign tax credit is available.

The slicing rule for ordering limitation on credit calculations may be structured in a number of ways. Foreign income subject to the lowest foreign tax may be treated as occupying lower tax brackets, or perhaps foreign income subject to the highest foreign tax. A proportionate rule may also be used. A common approach is to permit taxpayers to order their limitation on credit calculations in such a way as will produce the least amount of residence country tax, i.e. which maximizes the availability and use of foreign tax credits.

Further complications may be caused by the interaction of the schedular nature of tax treaties with the domestic tax base of the residence country. Tax treaties adopt a schedular approach in granting source country taxing rights (i.e. under Articles 6 to 21). Often domestic tax laws also adopt a schedular approach, calculating and taxing different types of income differently. Two schedular systems (treaty and domestic), applying to the same income, are unlikely to be the same and particularly this can have consequences in calculating the limitation on credit, especially where a type of income limitation is adopted. This can result in the need for apportionment rules in allocating foreign tax to particular types of income as determined for domestic law schedular purposes.

Some countries apply special mechanisms to the collection of domestic tax with respect to foreign source income. For example, a domestic agent (such as a local bank or bank branch) acting on behalf of a non-resident paying say dividends may be required to withhold tax from the payment of the (foreign source) dividends. Such matters are not covered by tax treaties, but can impact on the application of the foreign tax credit method. If the withholding tax is a final tax, then it may be possible for the withholder (agent) to reduce the amount of domestic tax withheld by the amount of any foreign tax credit available to the recipient (because the agent may know how much foreign tax was imposed on the dividends). However, if the domestic withholding tax is not final, then it is likely that the limitation on credit will be calculated in such a way that it is not possible for the withholder to calculate the foreign tax credit. In such a case, the taxpayer will have to declare the foreign source income and claim a credit for both the domestic withholding tax and the foreign tax. In such a case, countries invariably allow the taxpayer to apply the foreign tax credit first and maximize a claim for refund of domestic withholding tax credits.

As noted above, tax treaties often identify which foreign tax qualifies for a foreign tax credit, i.e. taxes covered by the treaty (Article 2). By contrast, unilateral foreign tax credit systems have to identify which types of foreign taxes are sufficiently similar to the residence country income tax to qualify for a foreign tax credit. This can mean that unilateral foreign tax relief is broader than tax treaty relief and raises issues as to which relief applies. As a general rule, domestic law often permits taxpayers to choose between tax treaty and unilateral relief, especially where unilateral relief is more generous.

The tax year of the source country may be different from the tax year of the residence country and the timing of tax installments and final tax payments can vary dramatically. A foreign tax credit system needs to relate foreign tax paid to a particular tax year. It may do this by associating the foreign tax with particular foreign source income or simply by granting a foreign tax credit for foreign tax paid within a particular year. These sorts of details are not covered by tax treaties and again are typically dealt with in domestic law.[25]

**Box 5**
**Use of Losses — Excess Foreign Tax Credits**

A resident derives 100 foreign source income and has 200 losses from domestic activities. The foreign income is taxed in the source country at the rate of 20%. The residence country eliminates double taxation in the form of granting a foreign tax credit. It requires domestic losses to reduce foreign income. It taxes the resident at the rate of 30%. It permits both losses and excess foreign tax credits to be carried forward for use in future years.

| | |
|---|---|
| Foreign Income | 100 |
| Source Tax @ 20% | 20 |
| | ----- |
| Income Net of foreign tax | 80 |
| Gross-up by Residence Country | 20 |
| | ---- |
| Taxable Income | 100 |
| Domestic losses | (200) |
| Residence Tax | - |
| Less Foreign Tax Credit (limited to residence tax) | - |
| | ---- |
| Carry Forward Loss (200 - 100 foreign income) | (100) |
| Carried Forward Excess Foreign Tax | 20 |

The use of the domestic losses against the foreign source income means that no residence country tax is due with respect to that income. This engages the limitation on credit meaning that no foreign tax credit is available. However, the residence country permits excess foreign tax to be carried forward. In effect, 100 of the domestic loss is converted into 20 carried forward excess foreign tax.

Finally, as with exempt foreign source income, there are issues as to how the foreign tax credit method interacts with the application of domestic loss relief. If losses (foreign or domestic) reduce foreign source income for which a foreign tax credit is available then the limitation on credit will be lower, i.e. the application of losses increases the likelihood of excess foreign tax credits. One way to look at this is that the losses have been converted into excess foreign tax and this raises the issue of the manner in which excess foreign tax can be used, if any.

[25] For example, see paragraph 32.8 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 14 of the Commentary on Article 23 of the UN Model Convention.

Again, foreign tax credit countries have a number of options as to how to deal with the interaction between losses and the limitation on credit. They may force the losses to be used against foreign source income, accepting that excess foreign tax credits may be worthless or at least worth less than the losses that gave rise to them (e.g. because domestic losses are involved and they could otherwise be set against domestic source income). Alternately, the losses may be quarantined so that they cannot be set against particular types of foreign source income for which foreign tax credits are available. Various versions of a proportionate rule may also be used. Again, a popular approach is to permit the taxpayer to choose whether the loss is used to offset foreign source income or not.

Finally, tax sparing is of particular importance for developing countries in concluding treaties with countries that adopt the foreign tax credit system. Tax sparing involves the residence country granting foreign tax credits for tax that the source country has intentionally forgone in order to attract investment. The appropriateness of tax sparing has been intensely discussed for many years and is noted in the Commentaries of the UN and OECD Model Conventions.[26] The form of tax sparing is typically unique and varies substantially from treaty to treaty (if it is available). However, a few general observations may be made.

The main difficulty for a residence country in administering tax sparing is identifying the tax forgone for which a foreign tax credit is to be granted. Almost inevitably, the tax forgone will be identified with respect to a particular type of income, e.g. income from manufacturing, agriculture, construction or even passive income such as dividends, interest and royalties. If the income identified is too general, the country granting tax sparing may have concerns if circumstances change, e.g. the economic environment changes such that the residence country's reason for granting tax sparing relief no longer exists. This has lead to a practice where more recent tax sparing provisions are often more targeted. In particular, a tax sparing provision may have a sunset clause, i.e. an agreed time at which it will cease to apply unless extended. Tax sparing may be limited to activity within a specific geographical area. Tax sparing is also commonly limited by reference to specific provisions in the source country's tax law and requires renegotiation if these provisions are altered in a material respect.[27]

[26] See paragraphs 1 to 11 of the Commentary on Article 23 of the UN Model Convention. See also paragraphs 72 to 78.1 of the Commentary on Article 23 of the OECD Model Convention, reproduced and elaborated on in paragraphs 16 to 18 of the Commentary on Article 23 of the UN Model Convention.

[27] See paragraph 12 of the Commentary on Article 23 of the UN Model Convention.

In all of these matters, the tax administration of the residence country has an interest in checking that tax sparing is appropriately claimed. It may require certain proof before accepting a claim for tax sparing. This may take the form of evidence that the income in question was declared in a tax return to the source country and specifically granted relief by that country. It will also be necessary to quantify specifically the amount of tax forgone and the residence country tax administration is likely to require evidence as to the manner in which the tax forgone is calculated. Some residence countries may require a certificate from the source country tax administration to support these matters. Nevertheless, a residence country may remain concerned at the possibility of relief in the source country (which is eligible for tax sparing) being manipulated and artificially claimed in circumstances where the relief is not intended to apply. In this context a residence country may incorporate anti-abuse rules into the tax sparing provision or reserve the right to apply domestic anti-abuse rules.

Once the application of tax sparing is determined and the amount of source country tax forgone is quantified, tax sparing raises few issues in addition to those generally raised by a foreign tax credit system.

## 2.3 Deduction of expenses

Whether a residence country adopts the exemption method or the credit method and whether it does it by tax treaty or unilaterally, it will need rules for allocating expenses between foreign and domestic source income. In the case of the exemption method, this is needed to ensure that expenses incurred with respect to exempt income do not reduce taxable income. In a foreign tax credit system, this apportionment is needed in order to appropriately apply the limitation on credit. This is particularly important where the foreign tax would otherwise exceed the domestic tax liability on the relevant foreign source income. It is common for an amount of cross-border income to be calculated differently by source and residence countries and questions about the deductibility of expenses are often the cause of this.[28]

Again, the allocation of expenses by a residence country between domestic source income and foreign source income or between foreign source income and other foreign source income is the sort of detail that tax treaties do no generally deal with. While tax treaties regulate to some extent

[28] Generally regarding residence country allocation of expenses between foreign source income and domestic source income, see Ault & Arnold (2010), note 1, pp. 458-60 and 471-3 and Harris & Oliver (2010), note 1, pp. 313-8.

deductions claimed in the source country (e.g. under Article 7 and its Commentary)[29] they have virtually no impact on the deductibility of expenses in the residence country. In principle, it is not contrary to a tax treaty for a residence country to discriminate against residents deriving foreign source income, whether by reason of application of tax rates, denial of concessions available with respect to domestic source income or the non-deductibility of expenses.[30]

As a matter of domestic tax law, the allocation of expenses by residence countries to foreign source income is often not very detailed. In general, there are two extreme approaches that a residence country may adopt and these reflect approaches to allocation of income between countries.[31] At one extreme, a country may adopt a transactional approach and seek to determine the extent to which a particular expense is incurred in deriving the foreign source income in question. Some expenses will be difficult to attribute, such as interest on a loan where there will be a need to trace the use of the funds borrowed in order to determine an appropriate allocation of the interest expense, in some cases a near impossible task.

At the other extreme, a residence country may adopt some form of overall apportionment approach for allocating expenses to foreign source income. For example, expenses may be allocated to particular income earning activities based on turnover or a mixture of factors such as assets, payroll and sales.[32] As with a formulary apportionment process to income allocation, the apportionment formula may be very general (e.g. one factor) or may become increasingly itemised until eventually the transactional approach is approximated. Often countries adopt a mixed approach. For example, it is common for expenses that are easily identified as directly related to particular income to be

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29 Even here there are substantial differences of opinion as evident in the differences between Article 7 of the UN Model Convention and the post-2010 version of Article 7 of the OECD Model Convention. In particular, Article 7(3) of the UN Model Convention provides some prescriptive rules as to the deduction of expenses in the country in which a PE is situated. Generally, regarding this provision, see Harris & Oliver (2010), note 1, pp. 159-62.

30 As discussed above at 1.3.1, the non-discrimination rules in Article 24 may provide limited exceptions but the rules in Article 24 do not prevent discrimination against deriving foreign source income per se. In particular, Article 24(4) only requires that a deduction be granted for a payment to a treaty partner resident if it would be available for a payment to a resident. It is permissible for a residence country to permit a deduction for an expense in deriving domestic source income, but deny such a deduction in deriving foreign source income, provided that deduction is denied irrespective of whether the expense is paid to a resident or a non-resident person.

31 It is also possible to permit the taxpayer some discretion in the allocation of expenses, but this possibility is discounted in the present discussion.

32 Corporate groups raise particular issues in this regard as they may be used in such a way as to itemize the allocation of expenses. So it may be that the apportionment occurs at the group level rather than at the level of individual corporations.

allocated to that income (e.g. cost of assets), whereas more general expenses are allocated on an apportionment basis (e.g. overheads). Generally accepted accounting practice can be particularly important in the allocation of expenses for tax law purposes, but is not always determinative.

Where expenses related to foreign source income exceed that income, the result is a foreign loss. Foreign losses have an intricate interplay with systems for the elimination of double taxation.[33] Many countries feel a need to quarantine foreign losses so that they cannot offset domestic source profits. Just as tax treaties do not extend to the allocation of expenses in the residence country, they do not extend to the treatment of losses from foreign activities. Domestic law of the residence country will determine the extent to which such a loss may be set against domestic source income or against foreign source income from other foreign activities.[34]

Countries that adopt the exemption method with respect to particular foreign activities (e.g. a foreign PE) often refuse to recognise losses from such activities. However, a few countries do allow such losses to reduce domestic source income, but on the condition that when the activities turn profitable those profits are not exempt to the extent that foreign losses were previously taken into account. This is commonly referred to as *clawing back* the benefit of the earlier use of the losses or *reintegration* of the loss.[35]

For a foreign tax credit country, it is natural that foreign losses are recognized. The question for such a residence country is whether those losses can only be carried forward for use against profits from the same foreign activity (quarantined), or whether they may be used against income from other sources, whether domestic source income or foreign source income. At some level, it might be suggested that the same approach should be followed as used in the foreign tax credit system, e.g. type of income, country-by-country or worldwide approach. This would suggest, presuming an ordinary foreign tax credit is adopted, that foreign losses should not be available to reduce domestic source income. However, in practice, many countries do allow that to happen. One reason is that the

33 Generally regarding foreign losses, see Ault & Arnold (2010), note 1, pp. 460-2 and 473-4 and Harris & Oliver (2010), note 1, pp. 322-4.

34 For example, see paragraphs 44 and 65 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the UN Model Convention.

35 In particular, the latter term is often used in Europe, as in Case C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-8061 (ECJ).

relief provided is often clawed back automatically under the foreign tax credit method in the future if the foreign activities turn profitable.[36]

Many countries permit, through one mechanism or another, the losses of one member of a corporate group to offset the profits of another member of the group. As a general rule, countries do not permit the losses of a foreign group member to offset the profits of a resident group member.[37] Again, this is a matter for domestic law that is not directly affected by tax treaties.

## 2.4 Underlying relief[38]

The domestic tax laws of most countries provide some form of relief from the economic double taxation of corporate income (taxation of corporate income when derived and again when distributed). As mentioned, model tax treaties do not deal with this form of economic double taxation, especially from the residence country's perspective.[39] In particular, the non-discrimination rule (Article 24) does not prevent a country from applying dividend relief to domestic source dividends while applying economic double taxation (classical system) to foreign source dividends. In practice, many tax treaties do provide relief from economic double taxation of corporate distributions in the residence country.[40] This relief is usually limited to dividends paid with respect to direct investment, i.e. parent corporations in receipt of dividends, and for this purpose a definition of direct investment is required, which may but likely will not reflect the definition for lower source country taxation of dividends in Article 10(2). Similarly, many residence countries unilaterally provide relief from economic double taxation of foreign source dividends.

Whether the relief from economic double taxation of foreign dividends by a residence country is provided under tax treaty or unilaterally, it usually takes the form of the exemption or credit method, in the latter case referred to as an underlying or indirect foreign tax credit. The general issues

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36 This happens if the losses are carried forward in the source country. Future source country income is exposed to full residence country taxation without a foreign tax credit when that income is sheltered from source country taxation by the losses.

37 Generally regarding cross-border use of group losses, see Harris & Oliver (2010), note 1, pp. 333-4.

38 For a general discussion of issues that arise on the taxation of foreign dividends by a residence country, see Harris, P. (2013), *Corporate Tax Law: Structure, Policy and Practice* (Cambridge: Cambridge University Press) pp. 367-80.

39 There is a limited measure for relief of economic double taxation of parent corporations in Article 10(2) from a source country's perspective.

40 For options in this regard, see paragraph 52 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the UN Model.

discussed above with respect to each of these methods also apply in the context of providing underlying relief, e.g. allocation of expenses, forms of limitation on credit, identification of creditable foreign tax. However, underlying relief raises additional issues.[41] If its availability is limited to parent corporations, then the type and level of shareholding required must be specified. Commonly, this can be as low as 10%, but much higher shareholdings are also used. There are issues as to whether only direct shareholdings count, or whether shares held through other related corporations count towards determining if the threshold is met, i.e. indirect holdings are also counted.

Whether the exemption or indirect foreign tax credit method is adopted, a system providing underlying relief must identify the type of distributions made by non-resident corporations that may qualify for the relief. Tax treaties, if they provide for underlying relief, rarely deal with this matter in any detail. Domestic tax law may be more specific as to whether only something that may be described as a "dividend" under corporate law can qualify or whether certain receipts that a domestic tax law may deem to be a dividend also qualify for underlying relief, e.g. interest paid on profit sharing debentures or convertible notes, liquidation distributions, returns of capital or the price paid on a share buy-back.

Indirect foreign tax credit systems raise additional issues. An indirect foreign tax credit system is a form of imputation system, i.e. corporation tax paid by the distributing corporation with respect to the profits distributed is imputed to the parent corporation. In addition, it raises issues of allocating and apportioning foreign tax paid with respect to corporate income to particular distributions. In particular, the distributing corporation may have paid corporation tax at various rates with respect to its profits. When it distributes only part of those profits, an indirect foreign tax credit system must determine which profits have been distributed.[42]

Different countries adopt different approaches in identifying which profits have been distributed for the purposes of an indirect foreign tax credit system. There may be an ordering rule based on when the profits were derived, e.g. first in first out. There may be an ordering rule based on the amount of corporation tax paid with respect to the profits, e.g. highest taxed profits distributed first. There may be an overall apportionment, e.g. all retained corporate profits are distributed proportionately. It is

41 Generally, see Harris & Oliver (2010), note 1, pp. 286-91.

42 For a comprehensive discussion of allocation of corporate profits and corporate tax to corporate distributions and the indirect foreign tax credit system as an imputation system, see Harris (2013), note 39, pp. 298-326 and 378-9 and the references cited therein.

also possible that the distributing corporation has some discretion in identifying the profits that have been distributed. Even if there is no such discretion, without complex rules for looking through and amalgamating the identity of members of a corporate group, some discretion can often be obtained through strategic distributions within a corporate group, i.e. through the use of mixer corporations.[43]

If tax treaties deal with underlying foreign tax relief for foreign source dividends, the provisions are usually limited to direct investors.[44] However, there is an increasing trend, particularly in European countries, to grant more arbitrary forms of dividend relief to non-corporate shareholders generally and extend this relief to foreign dividends. The relief often takes the form of a limited dividend exemption or, more commonly, a lower tax rate applied to dividends.[45]

## 3. Administering anti-avoidance rules

As noted above, tax treaties have two primary purposes - elimination of double taxation (heading 2) and the prevention of fiscal evasion. The latter topic is considered specifically in a separate paper,[46] but it is useful to make a few comments at this stage in the specific context of residence country taxation of foreign source income. As discussed, much of that taxation is not regulated by tax treaties directly. Nevertheless, residence country taxation of foreign source income is just as prone to tax planning, tax avoidance and tax evasion as the taxation of domestic source income. There are two aspects to this. The first is whether anti-abuse rules that apply generally also apply to the taxation of foreign source income. The second is whether the nature of foreign source income and associated relief from double taxation are prone to particular types of tax avoidance.

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[43] A mixer corporation is a non-resident holding corporation that is used to receive income taxed at various rates from related foreign corporations in order to *mix* the income so that it is on average taxed at a rate approximating the corporate tax rate in the residence (parent) country. In this way, when the mixer corporation distributes to the parent corporation, the parent corporation is entitled to a foreign tax credit that exhausts any residence country tax liability. The effect is to minimize the impact of the residence country's limitation on credit. Generally regarding mixer corporations and underlying foreign tax credits, see Harris & Oliver (2010), note 1, pp. 290-1 and 407-410.

[44] During the 1970s to 1990s there was a tax treaty practice by some European countries to grant dividend tax credits available to resident shareholders to treaty partner shareholders, especially portfolio shareholders. This involved relief from source country tax. Residence countries reciprocated by, in effect, granting direct foreign tax credits to the shareholder for tax that had only been paid at the corporate level in the source country. Most of these treaties have now been replaced or amended to remove this provision. See Harris (2013), note 39, pp. 351-4.

[45] See Harris (2013), note 39, pp. 375-8 and Harris, P. (2010), Cross-border Dividend Taxation in the 21st Century: the [Ir]relevance of Tax Treaties, *British Tax Review*, 2010, No. 6, pp. 573-88.

[46] See Philip Baker, Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion, Paper 9-A of this collection.

## 3.1 Application of domestic rules

Income tax laws commonly contain different types of anti-abuse rules. These might address specific issues such as excessive debt financing, transfer pricing, sale of loss corporations, use of service corporations, hidden profit distributions, dividend stripping, income splitting or assignment of income, etc.[47] Income tax laws also commonly incorporate or are subject to a general approach to tax law abuse such as a general anti-avoidance rule or substance over form doctrine. From a domestic law perspective, such anti-abuse rules typically apply to the taxation of foreign source income in the same manner as they apply to the taxation of domestic source income.[48] Further, as a general rule, because tax treaties do not limit the scope of a residence country's right to tax foreign source income they do not restrict the application of domestic anti-abuse rules to foreign source income.

## 3.2 Rules targeted at foreign source income

The nature of foreign source income and associated relief from double taxation are prone to particular types of tax avoidance. These are broadly of two types - those that manipulate whether the residence country is required to provide foreign tax relief and those that manipulate the time at which foreign income is recognized by the residence country and so subject to tax. The former is often, in principle, regulated by tax treaties whereas the latter commonly is not.

The circumstances in which the provision of relief for elimination of double taxation can be manipulated relate to the structural features of the form of relief. So, where the exemption method is available, taxpayers may seek to manipulate their circumstances so as to ensure relief in circumstances where the rationale for relief is not present. A good example of this is the one mentioned above, where the taxpayer arranges their affairs in such a way that the source country takes the view that the taxpayer does not have a PE situated in that country but the residence country does take that view. This can result in no source country taxation but the residence country nevertheless seeking to relieve the (non-existent) double taxation by exempting the profits of the taxpayer's activities in the source country (mismatch of PE characterization).[49] Another example is

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[47] Many of these domestic rules are discussed in Harris (2013), note 39, pp. 93-103 (transfer pricing), 176-80 (service corporations and assignment of income), 198-204 (excessive debt financing), 215-29 (hidden profit distributions), 439-89 (sale of loss corporations) and 583-6 (dividend stripping).

[48] For example, see Ault & Arnold, note 1, pp. 527-9.

[49] Article 23A(4) of the OECD Model Convention is intended to deal with such a situation, at least where the exemption in the source country is by reason of the manner in which that country has applied the treaty. Also see paragraphs 56.1 to 56.3 of the Commentary on Article 23 of the OECD Model Convention and paragraph 19 of the Commentary on Article 23 of the UN Model Convention.

where the taxpayer may elect to be taxed in the source country (and does so) so as to meet a subject to tax requirement for claiming an exemption in the residence country.

The foreign tax credit method can also be abused. The use of mixer corporations to avoid limitation on credit rules was mentioned above. Source countries have sometimes participated in the manipulation such as where they grant *designer* tax rates so as to maximize relief in the residence country. Scope of the relief may also be abused, such as where the residence country provides underlying foreign tax credits for a payment that is deductible in the source country. Here the potential for abuse may not be as great as under the exemption method, but residence country tax savings may still be pursued.[50]

Historically, the biggest problem for residence country taxation of foreign source income has been deferral of that taxation by retaining the income in a foreign corporate tax shelter. As corporations are separate legal entities and typically separate taxpayers, the controllers of a corporation (often high-wealth, high-tax rate individuals) can cause the corporation to retain profits in order to avoid the higher tax rates of their shareholders. This can happen in a purely domestic context if there is sufficient difference between the corporate tax rate and the highest personal marginal rate. However, when this is looked at internationally it is a particular problem because individuals have the possibility of retaining the profits of their controlled corporations in tax havens where they are subject to little or no taxation.[51]

As a response, numerous countries have enacted controlled foreign corporation rules. These rules can be complex but their general thrust is to tax resident shareholders on their proportionate share of profits of a non-resident corporation (whether the profits are distributed or retained) that is controlled by residents. At a conceptual level, controlled foreign corporation rules are an example of the tax law lifting the corporate veil. As usual with residence country taxation, outside of limited examples, tax treaties do not specifically regulate the application of controlled foreign corporation rules. The OECD Commentaries suggest that such rules are broadly consistent with tax treaties.[52]

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50 Generally regarding hybrid mismatches, see OECD (2012), *Hybrid mismatch arrangements: Tax policy and compliance issues* and Harris & Oliver (2010), note 1, pp. 345-68.

51 Generally regarding deferral in foreign controlled corporations and the use of intermediaries, see Ault & Arnold (2010), note 1, pp. 474-85 and Harris & Oliver (2010), note 1, pp. 296-312 and 388-415. Regarding the corporate tax shelter issue generally (including from a domestic perspective), see Harris (2013), note 39, pp. 144-69.

52 Generally, see Philip Baker, Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion, Paper 9-A of this collection.

Some countries' anti-abuse rules go further and apply to income derived through foreign corporations that are not controlled by residents. Here the target is to prevent the benefits available through the foreign corporation deferring repatriation to the residence country and so taxation of foreign dividends. Most commonly, such rules are only targeted at the deferral of tax on foreign dividends. However, some countries have introduced a general rule deeming income from shares that applies on a non-discriminatory basis. Again, these types of details are not addressed in tax treaties.

These anti-deferral rules have historically been targeted at all resident shareholders in foreign corporations, whether corporate or non-corporate. Globalization is now a substantial challenge to the application of anti-deferral rules as taxpayers are increasingly willing to move their country of residence in order to avoid them. This challenge is particularly dramatic in the case of corporate shareholders. For many years, the largest group of target shareholders subject to anti-deferral rules has been corporate shareholders, particularly parent corporations of controlled foreign subsidiaries. The rationale for taxing such corporations immediately on the profits of their subsidiaries was in order to prevent the avoidance of residence country taxation.

However, at a conceptual level, the taxation of corporations is a method of taxation at source, particularly the taxation of the corporation's shareholders. From this perspective, the application of controlled foreign corporation rules to parent corporations is a method of preventing deferral of residence country taxation by the parent corporation's shareholders. Increasingly, resident corporations are not owned solely by resident shareholders, at least not taxable ones. Indeed, there are many corporations, particularly widely held corporations, which are majority owned by tax exempt institutions (such as pension funds) and non-resident persons (including sovereign wealth funds).

In a globalising world with increasing fragmentation of shareholders, there is evidence that the application of controlled foreign corporation rules is having an increasing effect on the location of the parent corporation's residence. Application of controlled foreign corporation rules by residence countries makes less sense if a parent corporation's shareholders are not subject to residence country taxation in the same jurisdiction as the parent corporation. In the future, residence countries that wish to address the deferral issue may find that they need to target their anti-deferral rules more precisely at the persons (often high wealth resident individuals) that are subject to residence country taxation.

# 4. General issues in administering the taxation of foreign source income[53]

There are four core areas of tax administration - collection of information, assessment, dispute resolution and collection of tax. Thus far the discussion has focused on the rules (especially tax treaty rules) that must be used in making an assessment of tax due to the residence country with respect to foreign source income. The discussion has not considered directly issues pertaining to tax administration procedure and whether there are any particular issues with respect to these core areas of tax administration raised by residence country taxation of foreign source income.

## 4.1 Collection of information

Tax administrations typically have broad general powers to access information for purposes of making or checking tax assessments. This access may be either voluntary (e.g. by the taxpayer submitting a return) or forced (e.g. audit powers). These aspects of information collection are often related - the main reason why a taxpayer will be willing to voluntarily disclose information is because the taxpayer knows that if they do not disclose then the tax administration has the right to collect the information directly and impose penalties for failing to voluntarily comply. Accordingly, if the power of the tax administration to force information collection on the taxpayer is not available, there is an increased risk that the taxpayer will not voluntarily disclose.

In the context of foreign source income of residents, the main issue with respect to voluntary disclosure is the type of information that the taxpayer is required to disclose. As for forced disclosure, the main issue is how to force disclosure with respect to information that may only be available in a foreign country. Each of these issues is considered in turn.

### 4.1.1 Type of information to disclose

A person is likely to be required to declare information as to foreign source income in the person's tax return irrespective of the method adopted by the residence country for the elimination of double taxation. Some of this information will be generic in nature and reflect the information required with respect to domestic source income. This type of information may include declaration as to the quantum of income, the character of the income (i.e. whether it is business profits, dividends, interest, capital gains etc.) and deductions claimed with respect to the income.

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53 Generally regarding tax administration with respect to cross-border taxation of income, see Harris & Oliver (2010), note 1, pp. 452-66.

In addition, further information will be required because of the nature of the income as foreign source income and the impact of the treaty provisions discussed above. In particular, most residence countries treat foreign source income differently depending on the country from which the income is derived, and this is particularly a consequence of the bilateral nature of tax treaties. So it will be necessary for a taxpayer to declare the country in which the income is sourced and the type of relief for elimination of double taxation being claimed (if any). The latter may require the taxpayer to identify the precise treaty under which relief is claimed (and the basis upon which the taxpayer claims the benefit of that treaty) or whether unilateral relief is claimed (if available).

Where tax treaty relief is claimed the situation may be more complex. As noted above at 2.2, tax treaties incorporate a schedular system, but that system is unlikely to match precisely the domestic characterization of income according to which the taxpayer will be required to declare income. It is not realistic that a residence country has a specific form of tax return for every country with which it has concluded a tax treaty. Rather, a generic form must be used that has scope for inclusion of information relevant to the applicable treaty. The tax returns of most countries require foreign source income to be declared in a specific part of the return form separate from that for domestic source income. It is likely that it is the domestic rules for determining source that are used for declaring foreign source income rather than any inherent source rules incorporated in a particular treaty.

From here, tax returns are likely to provide a flexible mechanism for inclusion of further information relevant for the application of the particular relief claimed, whether treaty or unilateral relief. As mentioned, this information is likely to require identification of the tax treaty under which relief is claimed or if unilateral relief is claimed. It may also require identification of the article of a tax treaty under which the source country may tax this income. For example, this is important where the residence country adopts the exemption method under the treaty because, as discussed above at 2.1, the exemption method is typically only available where the source country has a right to tax under particular articles of the treaty (such as the articles dealing with immoveable property, business profits and employment income). This may also be important for purposes of the credit method because the residence country is only required to credit tax that is properly levied by the source country under the treaty and that will depend on the provision under which the source country taxes (e.g. the source country's right to tax is different for dividends and interest).

The type of information described above may be sufficient for purposes of applying the exemption method, including exemption with progression. Further information will be required where the residence country adopts the foreign tax credit method. In particular, the residence country will require information as to the amount of foreign tax imposed on particular items of foreign source income. For reasons described in the last two paragraphs, the allocation of particular foreign tax to particular foreign source income could in some cases be complex. In the case of unilateral relief, source country tax will have been imposed with respect to the source country's classification of income. This source country tax must be reallocated to income as classified by the residence country. This will happen if the schedular or global income calculation system in the source country is not the same as that in the residence country.

The application of tax treaties can make this conversion process more complex for foreign tax credit countries than in the case of unilateral relief. This is because the tax imposed by the source country has to be allocated to income as classified under particular provisions of a tax treaty. The residence country must then reallocate that tax as allocated to income as classified under the tax treaty to its own domestic classification of income. There can be no hard and fast rules in this regard and each foreign tax credit country is likely to adapt a system to its own circumstances. However, in perhaps the vast majority of cases faced by a residence country tax administration the reallocation process will be straightforward.

### 4.1.2 Forced disclosure

As a resident taxpayer is within the jurisdiction of the residence country tax administration, there are no legal restrains on requiring the resident taxpayer to declare foreign source income (as discussed above at 4.1.1) to the tax administration and demanding that the return be supported with relevant documentation. Failure by the resident taxpayer to declare required information will be met with a penalty under the domestic law of the residence country. As a general rule, most countries collect such penalties in the same manner as taxes, and in this regard the discussion below at 4.4 is relevant. However, a tax administration will not know whether to impose such a penalty unless it can independently verify that the requirements as to declaration of foreign source income have not been met. This is the power of audit which requires the use of entry, access and forced information gathering powers. The procedure for auditing with respect to foreign source income usually follows the same procedure and time limits as for domestic source income.

The use of forced information gathering powers by a residence country tax administration with respect to foreign source income raises serious jurisdictional issues. This is especially the case if the relevant information is beyond the physical jurisdiction of the residence country. The legal power of tax administrations to access premises, documents and other information is most always jurisdictionally unlimited. That is, a tax administration will have a right according its own country's law to access information wherever it is located, including in a foreign country. However, in the absence of agreement with a foreign country (e.g. through treaty) the tax administration of a particular country is likely to breach the law of the foreign country (either its general criminal law or a specific law such as with respect to confidentiality) if it tries to exercise its information gathering power there. Further, tax administrations often have strict limits on their right to delegate administrative powers to other institutions, whether the delegation is to a local institution or a foreign institution such as a foreign tax administration. So in the absence of an express power, a particular tax administration may not even be able to request that a foreign tax administration provide assistance in collection of information.

Even if a particular tax administration has domestic power to request assistance from a foreign tax administration in the forced collection of information, it is unlikely that (in the absence of a treaty) the foreign tax administration could comply with the request. This is because the foreign tax administration will have been established for the purposes of administering local taxes (not foreign taxes) and its powers, including its information gathering powers will have been granted exclusively for that purpose. This means that in almost all cases the foreign tax administration will (without more) have no domestic legal power to collect information for the enforcement of foreign tax laws.

Therefore, when it comes to enforcing residence country tax consequences of a resident taxpayer deriving foreign source income, lifting these limitations on exchange of information with the source country tax administration is critical. The potential for this exchange and easing these limitations is facilitated by tax treaties and, in particular, Article 26. Article 26(1) permits the competent authorities of the treaty partners (typically the tax administrations) to exchange information "as is foreseeably relevant for carrying out the provisions" of the treaty. It also permits exchange for the "administration or enforcement of domestic laws concerning taxes of every kind and description", whether imposed by the treaty partners, their political subdivisions or local authorities. Accordingly, the power to exchange information is substantially broader than the taxes covered by the distributive rules of tax treaties. Further, there is no requirement that the person with respect to whom the information is requested be a resident of either contracting state.[54] The UN Model Convention provides for the competent authorities to develop procedures for exchange of information through consultation.[55]

[54] For example, see paragraph 8.2 of the Commentary on Article 26 of the UN Model Convention.

[55] Article 26(6) of the UN Model Convention.

Exchange of information typically takes one of three different forms.[56] It may be provided to comply with a request of the competent authority of the treaty partner. Some information may be provided automatically and this is particularly the case with computer-generated records. Thirdly, the competent authority may provide information of its own initiative, i.e. spontaneously, such as where it feels that the competent authority of the treaty partner may view the information as relevant. Automatic exchange of information is particularly topical, especially in the context of residence country taxation of foreign source income.[57] Large sums of foreign source income find their way into foreign bank accounts and Article 26(5) of both the UN and OECD Model Tax Conventions specifically state that where information has been requested of a competent authority, that competent authority cannot withhold the information solely by reason that it is held by a bank or financial institution.

Historically, because Article 26 is located in tax treaties, exchange of information has not been available in the absence of such a treaty. This has meant that countries that do not have a broad tax treaty network have limited scope for requesting exchange of information. More recently, this has been remedied through two mechanisms. One is the proliferation of dedicated exchange of information agreements based on the OECD 2002 Model Agreement on Exchange of Information on Tax Matters.[58] The second is the 1988 Convention on Mutual Administrative Assistance in Tax Matters developed by the OECD and the Council of Europe.[59] Each of these mechanisms has broad exchange of information provisions. The 1988 Convention has become particularly important since a protocol came into force in 2012 that both opened the Convention to non-member states and restricted the ability of tax administrations to deny exchange of information based on bank secrecy. This Convention has the advantage of providing a multilateral solution to cross-border tax administration issues including exchange of information and assistance in collection of taxes. It also broadens the scope for bilateral and even multilateral tax audits.

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56 For example, see paragraph 5.4 of the Commentary on Article 26 of the UN Model Convention and the Inventory of Exchange Mechanisms at paragraph 30. In 2006 the OECD published a Manual on Information Exchange, available at http://www.oecd.org/ctp/exchange-of-tax-information/cfaapprovesnewmanualoninformationexchange.htm.

57 More recently, OECD member states and certain other countries have been working on more comprehensive forms of automatic exchange of information. Generally, see http://www.oecd.org/ctp/exchange-of-tax-information/. As late as 2009 the UN Tax Committee was working on a "Code of Conduct on Cooperation in Combating International Tax Evasion", in which exchange of information focused on exchange by request.

58 Available at http://www.oecd.org/ctp/exchange-of-tax-information/2082215.pdf.

59 OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at http://www.oecd.org/ctp/exchange-of-tax-information/Amended_Convention_June2011_EN.pdf.

## 4.2 Assessment

Based on the information collected, a tax law will provide for the making of an assessment or tax decision. These decisions are of two types, either self-assessment by the taxpayer or an administrative assessment, including an amendment of a self-assessment. The procedure for assessment of tax with respect to foreign source income usually follows the same procedure and time limits as for domestic source income. In particular, foreign source income of residents is commonly subject to tax by way of self assessment including not only the assessment of the primary tax liability but self assessment of the right to elimination of double taxation whether by exemption or foreign tax credit. Tax treaties do not usually affect the application of domestic assessment rules although there is a special rule in Article 25(2) that seeks to extend the assessment procedure where the mutual assistance procedure of the treaty is engaged.

One special issue regarding assessment of tax on foreign source income is the time at which elimination of double taxation becomes available in the residence country. This is particularly important where the foreign tax credit system is adopted, but can also be relevant for an exemption system, e.g. where the exemption with progression approach applies. Residence countries commonly require direct evidence that foreign tax has been paid and the assessment upon which it is based. Typically, no foreign tax credit is available until the foreign tax is paid. It is then a question of operation of the foreign tax credit system as to whether the credit is available for the tax year in which the foreign tax is paid, or whether it is available when the income subject to the foreign tax falls into charge, usually the latter.

## 4.3 Dispute resolution

Once an assessment or tax decision is set or accepted by the tax administration, there is scope for dispute with the taxpayer regarding, amongst other things, the quantum of the assessment. Tax laws typically provide two mechanisms for resolving disputes. The first is a review procedure internal to the tax administration, commonly called an "objection" procedure. If the taxpayer and the tax administration fail to reach agreement, there is usually a subsequent independent review. Often this will be to a specialist tax tribunal with the potential for further appeal to the general courts; although in some countries the appeal is directly to the general courts.

When the review procedure is projected into an international setting, often there are two tax administrations and two court systems that may engage in review of taxation of foreign source income, i.e. those of the source country and those of the residence country. From the residence country's perspective, the usual objection and court review procedures will apply to an assessment of foreign source income of a resident. The same is likely to be true of a source country assessment of, in its view, domestic source income of the non-resident. These procedures of the source and residence countries are independent of each other and won't necessarily resolve issues of double taxation (or double non-taxation). However, tax treaties provide potential for unified or coordinated administrative review in an international setting. The primary benefit of such a review is that, as it involves the authorities of both countries concerned, the taxpayer may be provided with a holistic solution to double taxation.

Article 25 provides for coordinated review by the competent authorities of the contracting states of taxation covered by a tax treaty (the "mutual agreement procedure"). This procedure may be viewed as a logical extension in a bilateral setting of the typical internal review (objection) procedure adopted by most tax administrations domestically. In the case at hand, where a resident taxpayer believes that they have been taxed with respect to foreign source income in a way that is inconsistent with a tax treaty, the taxpayer can instigate the mutual agreement procedure by approaching the tax administration of the residence country.[60] This does not exclude the taxpayer's right to proceed with a dispute in the court system of the residence country (or that of the source country). However, many tax administrations are reluctant to take up a taxpayer’s case if the matter is being pursuing through the domestic courts (and see further below).

Where the residence country competent authority (usually the tax administration) cannot resolve a case of double taxation presented to it, that competent authority is obliged to approach the competent authority of the other state with a view to resolving the issue bilaterally.[61] The residence country competent authority is only required to "endeavour" to resolve the case with the other competent authority and so the authorities are not bound to agree a solution. This is consistent with the internal review procedures of most countries. Indeed, a residence country may apply the procedural rules of its internal review procedure to the mutual agreement procedure.[62] However, Article 25 does include some procedural rules, such as that the taxpayer must present the case to the residence country

[60] Article 25(1).

[61] Article 25(2).

[62] For example, see paragraphs 16 and 20 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 9 of the Commentary on Article 25 of the UN Model Convention.

competent authority within three years of first notification of the taxation, and the UN Model Convention makes provision for the development of others.[63]

A legal difficulty with any mutual agreement between competent authorities is whether there is an internal law bar to the effectiveness of the agreement. For example, domestic law time limits may prevent a tax assessment being amended in favour of the taxpayer. Article 25(2) seeks to overcome this difficulty by prescribing that any agreement reached is to be implemented despite any domestic law time limits. Another difficulty is the interrelationship between any mutual agreement and court decisions. Some countries have an internal law provision that gives effect to a mutual agreement even if it is contrary to a court decision, but in others, the internal law does not permit the mutual agreement to override a court decision. The normal procedure would be for the mutual agreement to bind the tax administration, but not the taxpayer, much in the same manner as a tax rulings system. This would leave the taxpayer open to challenge the agreement in the courts. To prevent any potential inconsistency, it is common for implementation of a mutual agreement to be subject to acceptance of the agreement by the taxpayer and settling of any court proceedings.[64]

Most commonly, the mutual agreement procedure is used in disputes over whether a source country has taxed in accordance with a tax treaty, and transfer pricing disputes are the most common subject of this procedure.[65] These sorts of disputes are also important for residence countries. For example, presume that the resident taxpayer has a PE in the source country which it believes has been taxed beyond what is permitted by Article 7 of the relevant treaty. The residence country adopts the foreign tax credit method for elimination of double taxation and the source country taxation is more than taxation in the residence country (i.e. engages the limitation on credit). The resident may approach the competent authority of the residence country and this may result in a mutual agreement

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[63] The second sentence of Articles 25A(4) and 25B(4) of the UN Model Convention provides for the competent authorities to develop procedural rules in consultation. Particular procedural issues are discussed at paragraphs 20 to 46 of the Commentary on Article 25 of the UN Model Convention. In 2007, the OECD published a Manual on Effective Mutual Agreement Procedures, available at http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementproceduresmemap.htm.

[64] See paragraph 45 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 9 of the Commentary on Article 25 of the UN Model Convention and footnote 33 at paragraph 42 of the Commentary on Article 25 of the UN Model Convention. See also paragraphs 76 and 82 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 18 of the Commentary on Article 25 of the UN Model Convention.

[65] Regarding common types of disputes see paragraph 9 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 9 of the Commentary on Article 25 of the UN Model Convention.

procedure. If source country taxation is reduced as a result of that procedure, this will have an impact on the manner in which the residence country calculates the foreign tax credit.

A similar example is where a resident corporation has a subsidiary in the source/host country and the source country makes a primary transfer pricing adjustment under Article 9(1). The corresponding adjustment (see above at 1.3.2) required of the residence country under Article 9(2) is a common subject of the mutual agreement procedure. Another common subject for mutual agreement is determination of the appropriate article under which a source country can tax. As source country taxing rights vary depending on which article of a tax treaty is applicable, this will also impact on a residence country's obligation to eliminate double taxation.

A major issue with the mutual agreement procedure has been the lack of a requirement for the competent authorities to reach agreement. In recent years, this has been addressed in Model Conventions through the inclusion of an arbitration procedure.[66] The UN version is triggered where the competent authorities fail to reach an agreement within three years after the presentation of the case by one competent authority to the other. This is not an independent review of the taxpayer’s issues, but merely an extension of the mutual agreement procedure. The taxpayer has no express right to participate in this arbitration and in the UN version the arbitration can only be instigated by one of the competent authorities. There is no requirement that the arbitrators be independent; they may well be tax officials of the competent authorities. The taxpayer is not bound by an arbitrator’s decision.[67]

### 4.4 Collection of tax

Finally, at least when the assessment or tax decision is not disputed (or not capable of dispute), there is the issue of collecting tax or enforcing the decision. Here again there is usually two mechanisms. There is collection directly from the taxpayer and the taxpayer’s assets. Secondly, the tax laws of most countries also provide for situations in which recovery may be from a third party, e.g. a person owing money to the taxpayer such as a bank. Like other powers of the tax administration, the power to collect taxes and the mechanisms that may be used are a matter of domestic law.

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[66] Article 25B(5) of the UN Model Convention and Article 25(5) of the OECD Model Convention. Alternative A of Article 25 of the UN Model Convention does not contain an arbitration provision.

[67] See paragraph 76 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 18 of the Commentary on Article 25 of the UN Model Convention.

In the context of foreign source income of residents, often the residence country has the taxpayer and local assets physically within its jurisdiction for purposes of enforcing a tax assessment. However, there will be cases where a resident person has few assets in the jurisdiction and the person is not physically available for enforcement, e.g. in cases of artificial entities or where an individual has taken flight. Here the general position is the same as discussed above at 4.1 in the context of collection of information - irrespective of what the domestic law of the residence country provides, its tax administration will not be able to collect its taxes in a foreign country. Further, in the absence of legislative authority, most tax administrations are not empowered to collect the taxes of a foreign country requesting assistance.

Article 27 of both the UN and OECD Model Conventions provides for mutual assistance of competent authorities in the collection of taxes. Like the Articles on non-discrimination (24) and exchange of information (26), Article 27 is not limited to taxes covered by the distributive rules of the particular treaty. While an assisting tax administration will continue to use its domestic tax collection powers when providing assistance, the competent authorities are to settle by mutual agreement the mode of application of the Article.[68]

Article 27(3) provides for a competent authority to request of the other competent authority assistance in the collection of a revenue claim. A request may be made only if the taxpayer cannot "prevent" the collection of the claim under the laws of the requesting country. The other competent authority is then to collect the claim "in accordance with the provisions of its laws applicable to enforcement and collection of its own taxes..." Paragraph (4) makes similar provision for assistance in preemptive measures in the collection of revenue claims, referred to as "measures of conservancy". Under paragraph (8), a contracting state is not required to assist unless the requesting state has "pursued all reasonable measures of collection... under its laws or administrative practice..." or where the "administrative burden... is clearly disproportionate" to the taxes to be collected.

Under Article 27, a residence country seeking to collect tax with respect to foreign source income of its residents may request assistance with that collection of the source country. However, Article 27 is general in nature. The residence country may make such a request of any country (with which it has a treaty with a provision on assistance in collection) that may be able to provide that assistance, such as a country where the person has substantial assets.

[68] In 2007 the OECD published a Manual on Implementation of Assistance in Tax Collection, available at http://www.oecd.org/ctp/exchange-of-tax-information/oecdmanualonassistanceinthecollectionoftaxes.htm.

The OECD/Council of Europe sponsored 1988 Convention on Mutual Administrative Assistance in Tax Matters was discussed above at 4.1.2 in the context of exchange of information. This Convention also includes provisions on assistance in recovery of taxes (Articles 11 to 16), which were influential in the drafting of Article 27 of both the UN and the OECD Model Conventions. Again, an advantage of this Convention is that it provides a multilateral solution to cross-border tax administration issues including assistance in collection of taxes.