

Università Carlo Cattaneo – LUIC

International Tax Law a.a. 2017/2018

Double Taxation Relief

Prof. Marco Cerrato

International Double Taxation

Definition

- **International juridical double taxation:** *«imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods»* (OECD MC, Introduction, § 1)
- **International economic double taxation:** imposition of comparable taxes in two (or more) States on different taxpayers in respect of the same subject matter
- Methods for relieving international double taxation are primarily focused on juridical double taxation

International Juridical Double Taxation

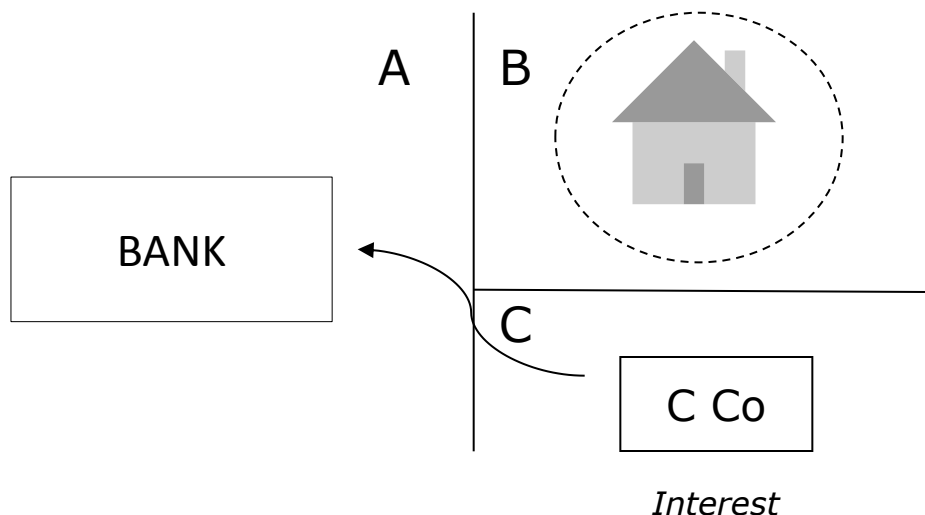
International juridical double taxation may occur in the following three scenarios:

- **Source-Source:** two Countries assert the right to tax the same income of a taxpayer because they both claim that the income is sourced in their Country
- **Residence-Residence:** two Countries assert the right to tax the same income of a taxpayer because they both claim that the taxpayer is a resident of their Country («dual-resident taxpayer»)
- **Residence-Source:** one Country asserts the right to tax foreign source income of a taxpayer because the taxpayer is a resident of that Country and another Country asserts the right to tax the same income because the income arises or has its source in that Country

Tax Treaty Relief

Source-Source

- Some cases of double taxation resulting from overlapping claims based on the source of income are dealt with by OECD MC rules on deeming source
 - Art. 11(5) OECD and UN Model Convention (MC): «*Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State*»



- B considers the interest sourced in B because the mortgaged property is in B
- C considers the interest sourced in C because the payer is resident in C

Tax Treaty Relief

Residence-Residence

International double taxation resulting from dual residence is typically resolved by tax treaties according to the «tie-breaker» rules:

Individual taxpayers

- Art. 4(2) OECD and UN MC:
 - a. Permanent home
 - b. Centre of vital interests
 - c. Habitual abode
 - d. Nationality
 - e. Mutual agreement

Legal entities

- Art. 4(3) OECD and UN MC: place of effective management

Tax Treaty Relief

Residence-Source

- International double taxation of the type residence-source is normally resolved by the so-called "distributive rules" of the tax treaties (Artt. 6-21 of the OECD and UN MC)
 - Both the contracting States have the right to tax (e.g. Art. 16: directors' fees)
 - Both the contracting States have the right to tax but source State's right to tax is limited (e.g. Art. 10: dividends)
 - Exclusive taxation in the State of residence (e.g. Art. 12: royalties)
 - Exclusive taxation in the source State (e.g. Art. 19(1)(a): government service)
- The residence Country has to grant relief from double taxation (Art. 23 of the OECD and UN MC)

Relief Mechanisms

- Three methods are commonly used by the residence State for providing relief from double taxation:
 - 1. Deduction method**
 - 2. Exemption method**
 - 3. Credit method**

- The OECD and UN MC envisage only the exemption and the credit method

- Many Countries use the deduction method to provide relief when no other means have been provided, i.e. when no tax treaty applies

Deduction Method

- The **Country of residence** taxes its **residents** on their **worldwide income** and allow them to take a **deduction for foreign taxes** paid in the computation of their taxable income
- Foreign taxes are treated as costs or current expenses of doing business or earning income in the foreign jurisdictions
- It is the least generous method for granting relief from international double taxation
- Although it is not envisaged by the OECD and the UN MC, it is used by several Countries that apply the credit method as a way of dealing with foreign taxes that do not qualify for the foreign tax credit (ex. foreign stamp duties)
- It creates a bias in favor of domestic investing and it is not neutral with respect to the allocation of resources between countries

Deduction Method / Comparison

The following example shows how the deduction method actually works in comparison with the other methods:

	<i>Deduction Method</i>	<i>Credit Method</i>	<i>Exemption Method</i>
Foreign source income	100	100	100
Foreign tax (40%)	40	40	40
Deduction for foreign tax	40	nil	nil
Net domestic income	60	100	nil
Domestic tax before credit (50%)	30	50	nil
Less: foreign tax credit	nil	40	nil
Final domestic tax	30	10	nil
Total domestic and foreign tax	70	50	40

Exemption Method

- The **Country of residence** taxes its residents on their **domestic source income** and **exempts** them from domestic tax on their **foreign source income**
- The exemption method completely eliminates residence-source international double taxation
- Two types of exemption:
 - 1. full exemption**
 - 2. exemption with progression** (Art. 23(A) OECD and UN MC)

Exemption Method

▪ Full Exemption Method

- The whole income which is taxed in the source State is exempt (i.e. not taken into account by the resident State for its tax purposes)
- In determining the tax on the rest of the income in the resident State, the income taxable in the Source country is not taken into consideration

▪ Exemption with Progression Method

- The whole income which is taxed in the source State is exempt (i.e. not taken into account by the State of residence for its tax purposes)
- In determining the tax on the rest of the income in the State of residence, the income taxable in source State is taken into consideration (relevant in case of progressive rates)

Full Exemption v. Exemption with Progression

T is a taxpayer
resident in **Country R**

Country A applies the
following **tax rates**:

- 20% [0 - 10.000]
- 40% [> 10.000]

Domestic source income	10.000
Foreign source income	10.000
Total income	20.000
Exempt foreign source income	(10.000)
Income taxable by Country R	10.000

Full exemption

Tax payable to Country R
= 10.000 x 20% = 2.000

Exemption with progression

Average tax rate
= (10.000 x 20% + 10.000 x 40%) /
20.000 = 30%

Tax payable to Country R
= 10.000 x 30% = 3.000

Full Exemption v. Exemption with Progression

- Under taxation systems with flat tax, the **exemption with progression** method leads to the same result as the full exemption method
- The **full exemption** method is inconsistent with the tax policy objectives of fairness and economic efficiency
 - if foreign taxes are lower than domestic taxes, resident taxpayers with foreign source income are treated more favorable than other residents
 - residents are encouraged to invest in Countries with lower tax rates
 - it may be justified when the foreign Country imposes tax at rates and under conditions comparable to those of the residence Country

Credit Method

- The residence Country provides its resident taxpayers with a **credit for income taxes paid to a foreign Country** against residence Country taxes otherwise payable
- Two types of tax credit:
 - 1. full credit**
 - 2. ordinary credit** (Art. 23(B) of the OECD and UN Model Treaties)

Full v. Ordinary Tax Credit

- **Full credit:** the residence State provides its resident taxpayers with a credit for the total amount of taxes paid to the foreign Country

- **Ordinary credit:** the credit for foreign taxes paid is usually limited according to three types of limitations:
 - **Overall or Worldwide Limitation:** foreign taxes paid to all foreign Countries are aggregated and the credit is limited to the lesser of the aggregate of foreign taxes paid and the domestic tax payable on the total amount of the taxpayer's foreign source income
 - **Country-by-Country or Per-Country Limitation:** the credit is limited to the lesser of the taxes paid to a particular foreign Country and the domestic tax payable on the taxpayer's income from that particular Country
 - **Item-by-Item Limitation:** the credit is limited to the lesser of the foreign tax paid on each particular item of income and the domestic tax payable on that item of income (in this context, an "item of income" means a category of income, e.g. interest income or shipping income)

Comparison between the Three Types of Limitation

- T is a taxpayer resident in Country R
- Country R applies a tax rate of 30%
- T earns 200.000 domestic source business income
- T earns foreign income as shown in the following table

	<i>Foreign Income</i>	<i>Foreign Tax</i>
Business income from Country B	100.000	45.000
Dividends from Country B	20.000	1.000
Business income from Country C	50.000	10.000
Interest from Country D	10.000	1.500
Total	180.000	57.500

Example 1 – Full Credit (No Limitation)

Total Income in Country R	380.000
Tax before credit (30%)	114.000
Foreign tax credit	57.500
Total tax in Country R	56.500

Example 2 – Overall / Worldwide Limitation

Country R tax before credit		114.000
Credit:		
<i>Lesser of:</i>		
(1) Foreign tax		57.500
(2) Country R tax on foreign income	180.000 x 30%	54.000
Country R tax after credit		60.000
Total tax payable		117.500

Example 3 – Per-Country Limitation

Country R tax before credit		114.000
Credit:		
(a) Country B		
<i>Lesser of:</i>		
(1) Foreign tax		46.000
(2) Country R tax on Country B income	120.000 x 30%	36.000
(b) Country C		
<i>Lesser of:</i>		
(1) Foreign tax		10.000
(2) Country R tax on Country C income	50.000 x 30%	15.000
(c) Country D		
<i>Lesser of:</i>		
(1) Foreign tax		1.500
(2) Country R tax on Country D income	10.000 x 30%	3.000
Total creditable taxes		47.500
Country R tax after credit	114.000 – 47.500	66.500
Total tax payable	66.500 + 57.500	124.000

Example 4 – Item-by-Item Limitation

Country R tax before credit		114.000
Credit:		
(a) Country B		
(i) Business income - <i>Lesser of:</i>		
(1) Foreign tax		45.000
(2) Country R tax on business income	100.000 x 30%	30.000
(ii) Dividends – <i>Lesser of:</i>		
(1) Foreign tax		1.000
(2) Country R tax on business income	20.000 x 30%	6.000
(b) Country C		
<i>Lesser of:</i>		
(1) Foreign tax		10.000
(2) Country R tax on business income	50.000 x 30%	15.000
(c) Country D		
<i>Lesser of:</i>		
(1) Foreign tax		1.500
(2) Country R tax on interest	10.000 x 30%	3.000
Total creditable taxes		42.500
Country A tax after credit		71.500
Total tax payable	71.500 + 57.500	129.000

Credit Method

Tax policy aspects

- Resident taxpayers are **treated equally** from the perspective of the total domestic and foreign tax burden on their foreign source income
 - It is **neutral** with respect to a resident taxpayer's decision to invest domestically or abroad
- provided that foreign taxes are lower than or equal to domestic taxes (if higher: no equality and neutrality)*
- On tax policy grounds, the credit method is recognized to be the best method for eliminating international double taxation

BUT

- It can be complex from the perspective of both the government and taxpayers

Treaty Aspects

- Art. 23(A) and (B) of the OECD and UN MC establishes the general principles of exemption and credit
- Each Country can establish detailed rules in its domestic law
- Some Countries provide an exemption for foreign source income or a credit for foreign taxes paid under their domestic law in addition to providing relief in their treaties
- Treaty relief can be more generous than the unilateral relief provided in domestic law

Allocation of Expenses

- **Countries that exempt** foreign source income **usually do not allow** their resident taxpayers **to deduct the expenses incurred** to earn that income
 - Countries can choose among two methods for attributing expenses to foreign source income:
 1. Tracing
 2. Allocation or apportionment

- **Countries that have a foreign tax credit system** **should allow** their resident taxpayers **to deduct the expenses incurred** to earn that income
 - The amount of a taxpayer's foreign source taxable income must be computed properly or the limitation on the credit will be improperly inflated

Tax Sparing

- Usually provided by tax treaties rather than by domestic law
- The tax sparing is a credit granted by the residence Country for foreign taxes that were not actually paid to the source Country but that would have been paid under the source Country's normal tax rules (e.g. under tax holidays, tax incentives, ...)
- In the absence of tax sparing mechanisms, the tax incentive provided by a source Country to attract foreign investments would be neutralized by the taxation of the investor in the residence Country
- Feature of tax treaties between **developed and developing Countries**
- The US is strongly opposed to tax sparing
 - inconsistent with the efficiency and fairness goals of its foreign tax credit
 - potential for abusive tax avoidance

Tax Sparing

The following example shows the shifting of the benefit of an incentive from the foreign investor to its home Country's treasury in the absence of tax sparing.

- **Country A - Developing Country**
 - Corporate tax rate = 30%
 - Ten-year tax holiday for foreign corporations that establish a manufacturing plant
- **Country B – Developed Country**
 - The resident taxpayer B establishes a manufacturing plant in Country A
 - Corporate tax rate = 40%
 - Credit method

Country A	
Income from Country A	1.000
Country A tax (holiday exemption)	0
Country B	
Income from Country B	1.000
Country B tax	400
Tax sparing credit	300
Total Country B tax	100

Tax sparing

In the absence of tax sparing:

- Country A would impose a tax of 300 and Country B would impose a differential tax of 100 on B

When tax sparing is granted:

- B would pay no tax to Country A
- B's tax liability to Country B becomes $400 - 300 = 100!$

International Economic Double Taxation

The main methods used to grant relief from **economic international double taxation** are:

- **Participation exemption**
- **Indirect or underlying credit**

Participation Exemption

- Several Countries use **participation exemption** mechanisms to eliminate the double taxation of:
 - **dividends from foreign corporations**
 - **capital gains from the disposition of shares of foreign corporations**

- Three key elements:
 1. level of share ownership
 2. nature of the income earned by the foreign corporation
 3. amount of foreign tax on the income of the foreign corporation

Participation Exemption

1. Level of share ownership

- Substantial ownership interest or participation

2. Nature of the income earned by the foreign corporation

- Participation exemption should be limited to dividends out of the active business (i.e. not passive) income earned by a foreign corporation

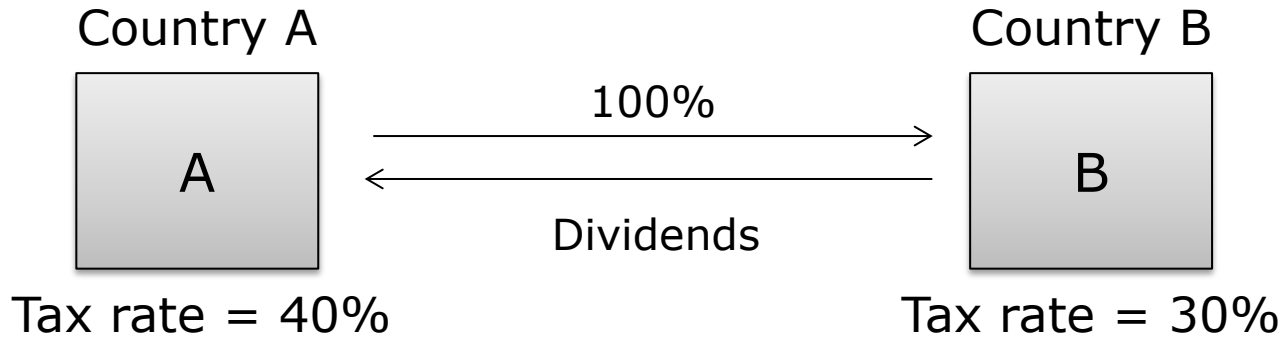
3. Amount of foreign tax on the income of the foreign corporation

- Some Countries limit their participation exemptions to dividends from foreign corporations established in listed comparable-tax Countries or in Countries in which they have concluded bilateral treaties that provide an exemption for dividends
- Other Countries have abandoned this limitation and rely on CFC or other anti-avoidance rules

Indirect or Underlying Credit

- Ordinarily, a foreign tax credit is granted only for foreign income taxes that a resident taxpayers pays directly
- The indirect or underlying credit is a credit granted to a resident corporation for the foreign income taxes paid by a foreign affiliated company when the resident corporation receives a dividend distribution from its foreign affiliate
- The domestic corporation should usually own a substantial interest in the share capital of the foreign corporation

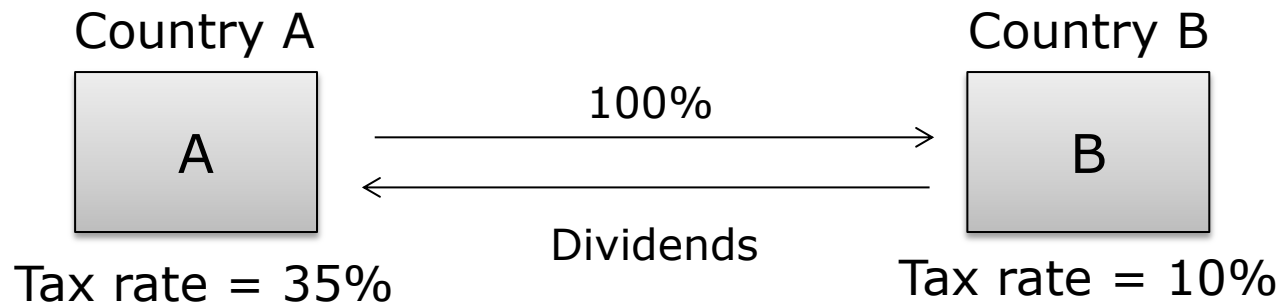
Indirect or Underlying Credit



B income	800
Country B tax	240
B after-tax profit	560
Dividends paid to A	560
A income:	
<i>Dividends received from B</i>	560
<i>Gross-up amount</i>	240
Total	800
Country A tax before credit (40%)	320
Credit for Country B tax paid by B	240
Net Country A tax	80

Indirect or Underlying Credit

The credit method may have the effect of discouraging domestic corporations from repatriating their profits earned abroad as dividend distributions

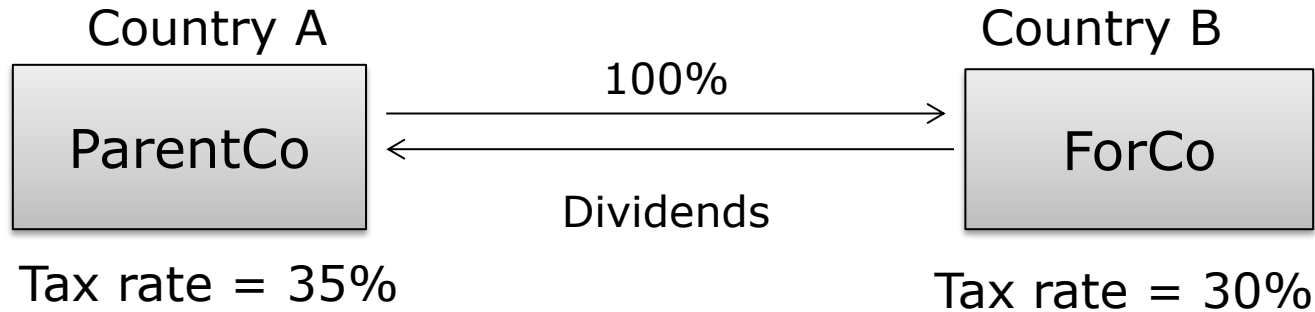


B income	100
Dividends paid by B to A	90
Gross-up amount	10
Income from A	100
Country A tax before credit (35%)	35
Indirect foreign tax credit for taxes paid by B	10
Country A tax	25

Indirect or Underlying Credit

- By retaining the profits in B, A can **defer indefinitely** the potential Country A tax of 25
- **Accrual taxation** would eliminate the deferral of residence Country tax on the foreign source income earned by residents through foreign affiliates
- CFC and foreign investment fund rules are used by some Countries to impose domestic taxes currently on certain income earned by foreign affiliates and foreign funds

Exemption v. Credit Method



	Credit	Exemption
ForCo		
Income of foreign subsidiary	100	100
Foreign tax	30	30
Dividends to ParentCo	70	70
Withholding tax (10%)	7	7
ParentCo		
Dividends received	70	70
Gross-up amount	30	
Taxable income	100	0
Domestic tax before credit	35	-
Foreign tax credit	37	-
Net domestic tax	0	0
Total tax	37	37

Exemption vs. Credit Method

- If the underlying foreign taxes paid by the foreign affiliate, plus any withholding taxes on the dividends, are
 - **at least equal** to the domestic taxes: the results of the two methods are the **same**
 - **less** than the domestic taxes: it shall be remembered that the domestic tax payable by the resident corporation is **deferred** until dividends are received
 - the longer the payment of dividends is deferred, the lower the present value of the domestic taxes on the dividends
- If the income of a foreign affiliate in which a resident corporation has a substantial participation is subject to foreign tax at a rate that, when combined with any withholding tax on dividends, approximates the tax rates imposed by the residence Country, the residence Country will not collect any tax on dividends from foreign affiliates in that Country even if it uses the credit method