



TAX JUSTICE BRIEFING

SOURCE AND RESIDENCE TAXATION

Is there a problem?

Income or profits which result from international activities such as cross-border investment may be taxed where the income is earned (the source country), or where the person who receives it is normally based (the country of residence). Residence taxation of income is based on the principle that people and firms should contribute towards the public services provided for them by the country where they live, on all their income wherever it comes from. Source taxation is justified by the view that the country which provides the opportunity to generate income or profits should have the right to tax it.

From the beginning of the 20th century, when income and profits taxation became the main source of government revenue in many countries, firms involved in international business soon complained of the very high rates of taxes that could result from taxation on both a source and residence basis. For example, if country A and country B both tax income at a rate of 50%, and a resident of A derives 100 units of income from a source within B, that income could first be taxed by B at 50% (paying 50 units in taxes) at source, and the remaining income

of 50 units could be taxed by A at 50% (paying taxes of 25 units) on the basis of residence jurisdiction. So the taxpayer would be left with only $(100 - 50 - 25) = 25$ units, paying an effective tax rate of 75%.

How can it be tackled?

Some countries decided unilaterally to limit their taxes on income derived from foreign sources. This could be done by completely exempting it from residence taxes, but this could encourage business or investors to go abroad to countries where tax rates are lower than at home. Alternatively, some provided a credit for foreign taxes paid, so that if the source tax rate is lower, the investor would pay the difference in the country of residence; but such a credit means that the income always bears taxes at the higher rate. Whatever solution was chosen would affect international investment flows, so it seemed better for countries to resolve the conflict or overlap between source and residence taxation by international agreement.

To prevent this double taxation, the League of Nations and its successors the United Nations (UN) and the Organisation for Economic Cooperation & Development (OECD) developed a series of model

treaties that led to the current set of over 2,500 bilateral income tax treaties, which provide the framework of the international tax regime. Fundamentally, the treaties strike a compromise between source and residence taxation. Some rights to tax are given to the source, and the residence country is required to relieve double taxation either by giving a credit for such source taxes paid, or by exempting the relevant income from its taxes. Generally, source jurisdictions retain their right to tax active (business) income, except for short-term activities, but give up some of their right to tax passive (investment) income.

So, the source country has the right to tax the business profits attributable to a branch of a foreign company (defined as a permanent establishment), as well as the profits of a foreign-owned company (subsidiary). In exchange, the source country agrees to apply no, or only a low, tax at source (described as a 'withholding' tax) on payments to residents of the other country, such as interest on loans, dividends on shares, or royalties on intellectual property. Thus, the main effect of the tax treaties is to reduce source-based taxation in favour of residence-based taxation of passive income (sometimes referred to as income from capital). The degree to which this is done depends on each treaty: capital-exporting richer countries prefer the OECD model treaty, which is more favourable to residence, while capital-importing developing countries tend to favour the UN model treaty, which is more favourable to source. For example, the UN model allows source taxation of short-term business activities, such as short construction projects, and fees paid to foreign service providers, such as accountants or consultants, even if they only enter the country for a short period.

Pros and cons of source and residence

Theoretically, one can imagine a world in which all countries adopted either pure residence jurisdiction or pure source jurisdiction. Economists tend to favour residence jurisdiction, both because they consider the source of income to be hard to pin down (income often has more than one source), and because they think residence jurisdiction promotes economic efficiency, since the decision where to invest should be unaffected by the tax rate.

However, pure residence taxation is unrealistic, for three reasons. First, countries are unlikely to give up the right to collect tax from foreigners doing business within their economy and territory. Second, pure residence based taxation would reduce revenues in poor developing countries, who rely heavily on source-based taxation, in favour of the rich developed countries where investors reside. Most importantly, residence taxation is much easier to evade or avoid, by channelling international investments through tax havens.

Strong protection of bank confidentiality and other secrecy provisions in havens make it hard for the residence country to get information about its residents' foreign source income. Residents can channel their income from the source country, through a country with an appropriate tax treaty, and then park them in a convenient haven. It is very hard for the residence country to try to tax this income, since it is very hard to find out about it. Indeed, if the income is not paid directly to the beneficiary in the country of residence, but parked in a trust or company to be reinvested or spent abroad, this may not be tax evasion but only avoidance. Even countries with highly sophisticated

tax administrations find it difficult to combat this, and for poorer countries it is virtually impossible.

Pure source taxation is also an option that has been favoured by some commentators, including academics from developing countries. The major problem with that option, however, is that it enables investors, especially transnational corporations (TNCs), to play countries off against each other to obtain the lowest source-based tax rate. This type of tax competition already exists for active business income. The semi-conductor chip manufacturer Intel, for example, legally avoids paying tax on any of its income outside the US by obtaining tax holidays from the various countries where it locates facilities. But the problem would get much worse if pure source based taxation were extended to passive income as well, since financial flows are extremely mobile. In that case it is doubtful whether any investment income would be subject to tax anywhere.

In addition, the problems of determining the source of income and of combating abusive transfer pricing (i.e., shifting profits artificially inside a TNC for a tax advantage) would become much more acute in a world of pure source taxation. The OECD countries introduced their controlled foreign corporation (CFC) regimes (dating back to the US Subpart F provisions in 1962) partly to combat these avoidance devices. Such regimes enable the residence country to combat the “parking” of foreign income in a subsidiary company or other entity formed in a low-tax haven, by taxing its income directly as part of the income of its parent or owners in the ultimate country of residence. If they were forced to abandon them as inconsistent with pure source taxation, opportunities for avoidance would be much greater than they are now.

Thus, a compromise which gives primacy to source-based taxation but keeps the option of residence-based taxation, still seems the best option to preserve the revenue base of both developed and developing countries.

Special issues with TNCs

More broadly, the distinction between residence and source is very hard to apply to businesses that operate in an internationally-integrated manner, as with most TNCs. Foreign direct investment by a TNC is very different from ‘portfolio’ investment by an independent investor. The TNC can set up a network of intermediary subsidiary companies, formed in convenient jurisdictions, especially to manage its assets and financial flows. Many of these involve passive or fictional business functions, such as providing insurance, raising finance by floating bonds and lending the proceeds, and owning physical assets (e.g. ships) or intellectual property (e.g. patents and trade-marks). The ‘active’ business profits of the TNC’s operating subsidiaries, taxable in source countries, will be reduced by fees and charges they must pay for these inputs. Yet such income flows need not be returned to the ultimate parent company unless and until they are needed to fund dividends to its shareholders. This enables TNCs legitimately to minimize taxation of their retained earnings, and to benefit from a reduced cost of capital compared to purely national firms.

It is extremely difficult to deal with this by the traditional approach of allocating rights to tax between the country of residence of the investor and the country of source of the income, since both source and residence are fluid concepts which can be manipulated. The main international initiative against international tax avoidance, the OECD’s drive against ‘harmful tax practices’, tries to do so

by strengthening both source and residence taxation, but only by the rich OECD countries, and by attacking tax havens, many of which are poor developing countries. The OECD's campaign could gain more political support if it aimed at strengthening the international tax system as a whole, rather than just trying to patch up the leakage of taxes from rich countries.

Strengthening the system

An important element in this, which is central to the OECD initiative, is improved exchange of information for tax purposes. An effective means to bring this about would be to impose withholding taxes at source on payments to non-cooperative countries. If this were done in a coordinated fashion, it would avoid the problem that the funds will just be driven to another country, and if done globally it would deal with the suspicion that only the rich OECD countries would benefit. Indeed, it would require the OECD countries themselves to be willing to supply such information even to developing countries, which they are not always willing to do.

The OECD has also tried to combat preferential tax regimes, defined as those aiming to attract mobile capital with no genuine business activity. The main means to do so is by treating companies with such business which are formed in low-tax jurisdictions as CFCs (controlled foreign

corporations), and taxable by the country of residence of the ultimate parent. However, it has proved very hard to agree what constitutes a genuine business activity. This is partly because OECD countries themselves also compete to provide tax breaks to attract some TNC business functions, such as headquarters regimes, and financial services.

Ideally, this problem, as well as all the difficulties faced by dividing rights to tax between residence and source countries, would be dealt with by taxing global businesses such as TNCs on a unitary basis, allocating their tax base by apportionment according to a formula which could fairly take account of the contribution each activity makes to the global profit (see separate Briefing on Unitary Taxation).

Meantime, all countries would benefit from re-defining the goal of the international tax regime as not just preventing double taxation, but also as preventing double non-taxation, in other words combating fiscal evasion and avoidance. Taxpayers should be willing to pay tax somewhere and fairly on their cross-border transactions, and this would help ensure that investment is allocated more fairly and efficiently.

This Briefing is based on a manuscript prepared by Reuven Avi-Yonah (University of Michigan), which was revised and edited following comments from other members of the Panel of Experts responsible for this Series.