**Taxation of Residents**

**A. Rate Scale and Personal Allowances**

The main reasons for taxing residents on their worldwide income have to do with the

fairness of the tax system. When a country adopts a progressive income tax rate scale for

individuals, it is usually motivated by the idea that it is fair for higher-income individuals to

pay proportionally more of their income as tax. Unless, however, the individual is taxed on

worldwide income, this goal may not be achieved for an individual with income from more

than one country. If the progressive tax rates are the same in each country and each taxes

only on a source basis, an individual receiving income from each country will pay less tax in

total to both countries than an individual who receives the same total amount of income from

only one of the countries. This is doubly unfair; not only are two like individuals taxed

differently, but individuals are obviously encouraged to split their income between the

countries, an avenue that is more likely to be availed of by a high-income taxpayer. There is

also a lack of neutrality in such a system because of the splitting incentive that it creates.

Given that it is not practical for a country to tax all individuals in the world on a

worldwide basis, the general policy that has been adopted is to tax only residents of a country

in this way. A country can generally enforce its tax claims against residents (i.e., persons

who have substantial personal contacts with the country), whereas a single source country is

unlikely to know the total income of a nonresident taxpayer and will face enforcement

problems in relation to income arising outside the country. From a policy viewpoint, it also

seems appropriate for the country taxing on the basis of personal allegiance of the taxpayer to

be the one that takes account of the taxpayer’s personal attributes. This concept relates not

just to the progressive rate scale but also to tax allowances, such as those relating to a zone of

tax-free income (which is closely related to progressivity), family size and composition,

medical costs, and subsidies for home ownership.

Conversely, for nonresidents, this approach implies flat-rate taxation of income

sourced in a country and no tax allowances for personal attributes. If residence is changed

part way through the tax year, then the taxpayer should change from one regime to the other

and allowances should be adjusted to account for the fact that the entitlement is for only part

of the year.

In practice, this approach to taxation of residents and nonresidents is often not fully

realized. While dividends, interest, and royalties received by nonresidents are generally taxed

on a flat-rate basis, the progressive rate scale is often applied to many other forms of income

of nonresidents (although the zone of tax-free income is often not applied). Personal

allowances (especially those applied by a developing or transition country to an expatriate

from an industrial country) are often not significant in revenue terms in relation to

nonresidents because of the small number of taxpayers affected. Hence, it is easier from an

administrative perspective to apply them to all individual taxpayers and not just to residents

or at least to apply them on a whole-year basis to any individual who is resident for part or all

of the tax year.

Confining personal reliefs to residents of a country does not infringe the

nondiscrimination rules of tax treaties, which generally seek to ensure that residents and

nonresidents are treated alike under the tax law of a country. The reliefs are recognized as

part of the residence jurisdiction of the taxing country, so that residents and nonresidents are

not treated as being in the same circumstances, which is a threshold condition for the

application of the nondiscrimination principle.72 As tax treaties otherwise do not deal with

personal reliefs, the tiebreaker rule in the tax treaty that addresses dual residence will not

carry over into domestic law for this purpose. Hence, a dual resident will be entitled to the

personal reliefs in more than one country, and a special rule in domestic law limiting

entitlement to reliefs in such cases is necessary if it is desired to track the tax treaty rule. For

developing and transition countries, this qualification seems an unnecessary refinement.

**B. Expatriates**

There are, however, a number of refinements that need to be considered by

developing and transition countries in the taxation of expatriate employees who become

residents of the country for a limited time. Expatriate employees will usually be brought into

a country where the skills necessary for a particular job are lacking in the country and hence

they will usually be very highly paid—especially in comparison with the general level of

wages in the country. They can be employed either by foreign investors or by local

employers. While in the past when colonial attitudes prevailed, foreign investors may have

been inclined to use expatriate employees for all senior positions whether or not local skills

were available, this position has now generally changed for cost reasons and out of greater

sensitivity to national sentiment. It will be assumed in what follows that the expatriate

employee is providing skills that are in short supply in a country and that the country wishes

to encourage—or at least not discourage—the importation of the skills.

For the purposes of the discussion we can distinguish several different situations in

which expatriate employees will be used in a country. First, there is the person who comes in

to do a specific task and leaves when the task is complete; the stay is very short term. Such

persons will generally not become residents under the domestic law of the country visited

and, in the case of employment by a foreign resident investor, will often not be taxable on

their employment income by reason of either tax treaties or provisions in domestic law that

set time limits on source taxation of employees. Second, there is the person who comes for a

more extended stay, say, six months to two years, but who leaves all or part of the person’s

family and a permanent home behind in the home country. This person will generally become

a resident of the country where the work is performed under a 183-day rule while remaining

resident in his or her home country, and under tax treaties residence will usually be allocated

to the home country by the tiebreaker rule. Third, there is the person who comes for a yet

more extended stay, but always with the intention of returning to the home country (as

evidenced by the ownership of property there and the limited period of the assignment). This

person may cease to be a resident in the home country for the period of the assignment, but,

if not, residence will usually be allocated by tax treaties to the country where the work is

being performed. Finally, there is the person who, at the outset, or more usually after an

initial period in the country, decides to remain in the country and “go local.” This person will

usually cease to be a resident of the home country entirely.73

Because of the high costs involved with expatriate employees, employers will usually

require them to go local after two or three years in the case of placement in an industrial

country and after a longer period, say, three to five years, in developing or transition

countries; that is, they are thereafter treated in the same way as local employees and do not

receive special expatriate allowances. The basic structure of the remuneration of employees

in the second and third categories above (which are the most common problem cases) will be

to provide them with salary and benefits designed to keep their after-tax salary before the

assignment intact, compensate them for the additional costs incurred as a result of the

assignment, and provide them with a bonus for undertaking the assignment, which will often

be viewed as having an element of hardship (such as separation from family, personal

security and general living conditions in the country of assignment, and complication of

personal affairs).

Typical benefits will thus include free or subsidized accommodation in the country of

assignment, payment of private education fees for children, free airfares between the home

country and the country of assignment on a regular basis, tax supplements to remove

additional tax burdens and free access to specialist tax advice, special pension scheme

arrangements, special medical insurance, free car and driver, and general security

arrangements, plus a bonus of, say, 25–50 percent of salary.

***1. Rate Scale***

If an expatriate has become a resident of a developing or transition country under its

law, taxation of worldwide income under the progressive rate scale will occur. The

appropriateness of the rate scale to the expatriate thus becomes an issue. Generally, it will

have been enacted with local incomes in mind. This means in many cases that the maximum

tax rate is reached very quickly in comparison with industrial country tax rate scales, because

of the generally lower level of local incomes. The result is a greater tax burden on the

expatriate than in the home country, even if the maximum tax rates in the countries are the

same. There is also a tendency for maximum tax rates in developing and transition countries

to be higher than in some major industrial countries.74 The employer thus will pay a tax

supplement to the employee to eliminate the additional taxation and, because the tax

supplement is really just additional salary, it should also be taxable and grossed up for the

additional tax accordingly.

To obviate this problem, some countries provide in effect special tax rate scales for

expatriates (by giving special additional personal allowances or by stretching the tax

brackets) and do not impose tax on tax supplements. Both of these measures represent

generous treatment of expatriates. They may be risky in a political sense as favoring wealthy

foreigners, but they may send a very positive signal to both foreign investors and to potential

expatriate employees. The amount of revenue at stake in terms of overall revenues will

usually be small in view of the small numbers of employees involved.

***2. Fringe Benefits***

The case of fringe benefits given to expatriates is clearer, however. Benefits that are

viewed as simply part of a person’s working conditions are not generally taxable as fringe

benefits (such as pleasant office accommodation, access to labor saving technology, or

payment of costs of work-related travel). It can be argued that although many of the benefits

received by expatriates would amount to taxable fringe benefits if received by local

employees, in the case of expatriates they are simply part of the conditions of work in the

country. Thus, free accommodation in the country of work when the expatriate has left

family in a residence in the home country and airfares to return home on a regular basis are

little different from payment of the cost of work-related travel. Arrangements to ensure

personal security may also be regarded as part of the work conditions.

In addition, taxation of fringe benefits in many countries takes account of

disadvantageous work conditions (such as working in remote locations), and, again, the

expatriate situation can be assimilated into this thinking. For example, while the expatriate

may have sent school-age children to a public school back home, the only realistic option for

language and cultural reasons may be to send them to a private school in the country of work

to get a comparable education that will allow the children to be absorbed back into the public

schools on return home. Free provision of health care up to the standard in the home country

can be justified in the same way.

Hence, provided the rules are carefully framed and judiciously enforced by selective

audits of expatriates to prevent abuses, nontaxation of such benefits can be justified on the

basis of the special position of the expatriate. Indeed, this approach can be generalized for the

converse case where residents of the country become expatriates in another country, although

in practice legislation on this topic will be much rarer. A provision to this end follows:

1. A foreign service allowance paid in respect of the additional expenses

incurred by reason of employment in *X* is exempt income [in an amount not

exceeding x percent of income (apart from this exemption)].

2. Paragraph 1 does not apply to any allowance in respect of income tax payable

in *X*. Regulations may further limit the exemption provided under paragraph 1.

3. This article applies to a taxpayer if (a) the taxpayer was a resident of another country under its tax law

immediately before undertaking the employment in respect of which the

allowance is paid;

(b) the taxpayer became a resident of *X* for tax purposes solely as a result

of carrying out the duties of the employment; and

(c) the employment in *X* lasts no longer than three years.

As indicated by the material in the article in square brackets, the exemption may

be limited to a percentage of the taxpayer’s income before the exemption is applied,

which is a method to limit abuse (e.g., to prevent an employer from paying such an

employee a relatively low salary and a substantial foreign service allowance). A

limitation is imposed by paragraph 2, which provides that the exemption does not extend

to allowances in respect of income tax (tax supplements) that the individual may have to

pay in *X*. Paragraph 3 provides a special test to determine whether the person is entitled

to the allowance, based on where the person was resident before moving as a result of the

person’s employment, and limits eligibility to the allowance to employment in the

country for a maximum of three years.

***3. Foreign-Source Income***

The next problem is the treatment of income of the expatriate derived outside the

country where the work is carried out. As already noted, expatriates in the second

category referred to above will normally be treated as residents of the home country

under the tiebreaker rule in tax treaties, whereas those in the third category will usually

be treated as residents of the country where the work is performed. Depending on the

precise terms of the treaty, the effect on the second category may be to eliminate taxation

by the country where the work is conducted on income derived by the expatriate from

sources outside that country and to limit or exclude taxation by that country on dividends,

interest, royalties, and other kinds of income derived from sources in that country. For the

third category of expatriate, the effect of tax treaties will usually be to permit unlimited

taxation of their worldwide income by the country where the work is performed and to

limit or eliminate taxation in the home country of income derived by the expatriate from

sources in the country of work, the home country, or other countries. Where there is no

tax treaty, there will frequently be unrelieved residence-residence double taxation for

both the second and third categories. The overall tax position is thus complex and very

likely to lead to excessive tax burdens.

If the country where the work is to be done wishes to attract the skills of

expatriates, it may seek to deal with the problem in its domestic law. As with fringe

benefits, the simplest mechanism is to exempt for a limited time income (other than

employment income) derived by the expatriate from sources outside the country. An

example of possible statutory language is as follows:

The foreign-source income of a resident of *X* is exempt income if

(a) it is not employment income;

(b) it does not benefit from a tax reduction under a tax treaty entered

into by *X*;

(c) the taxpayer became a resident solely as a result of employment

exercised in *X*; and

(d) the employment in *X* lasts no longer than three years.

***4. Pensions and Social Security***

It is common in many industrial countries for higher-paid employees with special

skills to become members of private pension schemes. Under the tax law of industrial

countries, the contributions to, income of, and distributions from the pension scheme will

usually be subject to favorable tax treatment as a means of encouraging the employee to

save for retirement and so not require support from the state in old age. When such a

person comes to a developing or transition country as an expatriate employee, it will

often be found that the country has no similar provisions in its laws (because of a lack of

pension arrangements for old age in developing countries or because of full state

provision of pensions in transition countries), or that such provisions as do exist do not

apply to foreign pension schemes, or that ceilings on tax-favored contributions to local

pension schemes are low by international standards. As entitlements under private

pension schemes are often not portable between schemes within a country, let alone

across international borders, the expatriate usually has no option but to remain a member

of the pension scheme in the home country. The result is an increased tax burden on the

employee and employer simply to maintain the existing pension entitlements of the

employee, which will not come into effect until many years after the employee leaves the

developing or transition country.

Although tax treaties increasingly are seeking to deal with this problem, most

existing treaties do not.75 Hence, countries may wish in their domestic law to recognize

the position of foreign pension schemes and to seek to remove the tax problems they and

their members currently experience. How this is to be achieved depends on the existing

arrangements for domestic pension schemes in the country where the work occurs. If the

country has schemes similar to those used in most industrial countries, then it is possible

to extend the same preferential treatment to foreign schemes on the basis of reciprocity.

Alternatively, if there are no such schemes or if reciprocity is difficult to achieve, a

deduction may be provided for contributions from expatriate employees and their

employers to pension schemes in the home country of the employee limited by reference

to some proportion of salary and employer contributions (say, 10 or 15 percent).

Social security taxes present similar problems, especially in transition countries

where they can amount to up to 50 percent of payroll before tax. Although such taxes are

separate from income taxes and are not covered by tax treaties, they are intimately related

as far as the employee is concerned, especially as regards provision for retirement. An

expatriate employee (or the employer, depending on where the tax is formally levied) will

often find that social security contributions must be paid in respect of the employee’s

salary in both the home country and the country where the employee is working on the

basis of residence in each country (the definition of residence under the social security

tax law being in question here, but with similar issues to the income tax).76 There will

generally be no relief from this double taxation, and in addition the expatriate employee

or employer will often be insuring privately in respect of some of the matters that may be

covered by the social security system (such as medical treatment) because of the

difficulties of extracting adequate benefits from the systems of developing or transition

countries in such cases. Even if there is no double tax, the local tax may be quite high.

For expatriate employees, the most relevant social security system is that of the

home country, because they will avail themselves of very few or no benefits under the

system of the country where the work occurs. Hence, it is sensible for the country where

the work is carried out not to levy its social security tax on expatriate employees and at

the same time to deny benefits under its system. This leaves the matter to be dealt with

under the system of the home country or private insurance. Social security totalization

agreements are nowadays being entered into between countries to deal with these kinds

of problems, but the development of such treaties lags far behind tax treaties **C. Relief from Double Taxation**

In industrial countries, the major residence country tax issue is generally seen as

the relief of double taxation on income that has been taxed at source in another country.

For developing and transition countries, this issue is less of a problem because residents

will derive much less income from foreign sources. So far as there is foreign income, it

will frequently be the result of (often illegal) capital flight to low-tax jurisdictions, in

which event the problem for the residence country is detection and taxation of the

income, not the relief of double taxation. Hence, the discussion of this issue will be fairly

abbreviated and will not delve into all the well-known intricacies of credit and exemption

systems of industrial countries.

It is necessary to distinguish among four basic methods in this area. The first is

for a country not to assert jurisdiction to tax foreign-source income of residents (either at

all or for selected types of income). This territorial approach to taxation (taxing only

income sourced in the country) means that the country is not following the usual

international norm of worldwide taxation of residents and so is not strictly a method for

relieving double taxation as residence-source double taxation will simply not arise for its

residents.78

The second method is the exemption system, under which foreign-source income

is exempted in the country of residence. If the exemption is unconditional and the

exempted income does not affect in any way the taxation of other income, then in

substance the result is the same as a purely territorial system. Most exemption systems

are not of this kind and so are to be distinguished from territorial systems. Most countries

using an exemption system adopt exemption with progression, under which the total tax

on all income of a resident is calculated, and then the average rate of tax is applied to the

income that does not enjoy the exemption.79 Exemption systems are also increasingly

subject to various conditions to ensure satisfaction of the assumption underlying the

system (that the income has been taxed in the source country at its ordinary rates).80

These conditions can consist of subject-to-tax tests (including the specification of tax

rates) or selective application of exemption to foreign countries under domestic law or

tax treaties.81 In particular, the exemption is usually not given where the source tax has

been reduced or eliminated by a tax treaty. The result is that there are no countries

asserting jurisdiction to tax worldwide income that give an exemption for all kinds of

foreign income; where a country is referred to as an exemption country, this generally

means that it provides some form of exemption to business income, dividends received

from direct investments in foreign companies, and often employment income, with a

credit being used in other cases.

The third system is the foreign tax credit system under which a credit against total

tax on worldwide income is given for foreign taxes paid on foreign income by a resident

up to the amount of domestic tax on that income. This limit is designed to ensure that

foreign taxes do not reduce the tax on the domestic income of residents and is calculated

by applying the average rate of tax on the worldwide income before the credit to the

foreign-source income. In its simplest form, this limit is applied to foreign income in its

entirety, without distinguishing the type of income and the country where it is sourced.

The fourth system is to give a deduction for foreign income taxes in the

calculation of taxable income. While this system is used in some countries, often as a

fallback from a foreign tax credit where the credit may not be of use to the taxpayer,82 it

is not widely accepted as a method for use on its own and, more specifically is not used

in tax treaties.

It can be argued that relief of double taxation in either credit or exemption form

involves a number of complexities that are best avoided by developing or transition

countries. Pure territorial taxation, however, simply invites tax avoidance through the

moving of income offshore, and once qualifications on the pure territorial principle are

admitted, such as limiting it to certain kinds of income, it is hard to see that any great

simplicity is achieved as problems of characterization of income arise, as well as

incentives to convert income from one form to another. Similar difficulties arise when a

conditional exemption system is used. For this reason, a simple foreign tax credit system

is probably suitable for most such countries—it asserts the worldwide jurisdiction to tax

income of residents and does not require significant refinements of calculation. It leaves

open the greatest scope for elaboration of the system by domestic law and tax treaties in

the future without having to repeal or modify any exemption (often a difficult process

politically because of entrenched interests). Given that tax treaties are premised on an

item-by-item foreign tax credit limit, rather than on a worldwide limit aggregating all

foreign income of the taxpayer, the item-by-item limit is probably easiest to use in

domestic law.83

Whichever double tax relief system is adopted, some method of apportioning

deductions between domestic and foreign income will be necessary. Where deductions

allocated to foreign income exceed that income, the loss should not be available for use

against domestic income. In practice, most credit countries do end up with some cases of

effective exemption for foreign income.84 One possible example in this context is in

relation to the foreign income of expatriates discussed above.

Tax treaties invariably contain an article for relief of residence-source double

taxation (they are built on the assumption that each country will assert jurisdiction to tax

the worldwide income of residents, which is another reason for asserting this jurisdiction

in domestic law). The only methods specified in tax treaties are exemption and credit, but

there is no need for the treaty method to follow that used in domestic law. Some countries

have no relief method under domestic law, so that the only relief is under treaties,85 while

some countries have the credit method in domestic law but use the exemption method for

selected kinds of income in treaties. Where the country has the credit method in its

treaties, this is not generally regarded as preventing it from using the exemption method

in domestic law, as exemption is seen as more generous than the credit method and

therefore not inconsistent with the treaty obligation. Where the exemption method is

adopted by tax treaties, the exemption-with- progression system is usually expressly

authorized.

Special double tax relief rules are often provided for foreign direct investment. As

already noted, the exemption system is often targeted to foreign-source business income

and dividends received by a resident company from a direct investment in a nonresident

company. Direct investment in a foreign company is equated with business income to

ensure that no bias is created as to the business form used. If an exemption is granted for

the business income of a branch in a foreign country, then it should make no difference

that the business income is generated by a subsidiary in that country and then repatriated

as dividends. By parity of reasoning under a credit system, a resident company should get

a foreign tax credit not only for foreign tax paid by a branch but also for foreign tax paid

by a subsidiary. This credit, referred to as an underlying or indirect foreign tax credit, in

practice involves a number of complexities that most developing or transition countries

would do well to avoid. It needs to be recognized, however, that failure to grant an

indirect credit creates a bias against investment abroad by residents of the country in the

form of subsidiaries. If such investment becomes important to the country, the indirect

foreign tax credit issue should be addressed either in tax treaties or in domestic law, or

both.

The article in tax treaties on relief from double taxation may also contain special

rules for direct investment in a developing or a transition country by a foreign investor to

preserve the effect of tax incentives granted by the developing or transition country. This

topic is discussed in relation to tax sparing in chapter 23.

**D. Capital Flight**

The more important residence tax problem for developing and transition countries

is capital flight. Many residents, especially those with the greatest wealth, will seek to

send their wealth abroad. They may be concerned about devaluation of their own

currency and wish to hold foreign currency, which may not be legally possible in their

countries; they may be afraid of confiscation (by the state or criminal gangs) or civil

unrest; and they may seek not to pay tax on the income produced by the wealth, which

itself may have been obtained by illegal means or may represent income that was not

declared for tax purposes. Whatever the reasons in any given case, it is clear that capital

flight from developing and especially transition countries is a major problem; the need of

these countries, on the contrary, is to retain domestic capital for productive local

investment.

Most of this fleeing capital finds its way to tax havens, which may be defined for

this purpose as low tax jurisdictions that have bank and other secrecy laws that allow the

ownership of assets to be concealed. For transition countries, it is well known that Cyprus

is a major destination of nervous capital. For developing countries, there are any number

of other tax havens only too willing to assist. Indeed, so lucrative does the business seem

that many developing and transition countries actively consider turning themselves into

tax havens.

If the money simply finds its way into an anonymous bank account and the

income earned thereon is not declared for income tax purposes, then assuming that the

residence country asserts jurisdiction to tax the income, this is a case of tax fraud

(deliberate nondisclosure). The problem here is one of detection and tax administration.

More sophisticated taxpayers may wish to ensure that no tax liability arises in respect of

the wealth, and there are a number of stratagems that they can employ. The simplest form

is to invest in shares in a tax haven company that in turn simply invests in a very safe

form (such as U.S.-dollar denominated bonds with a high credit rating) and accumulates

the interest income for further similar investment. If the shareholder desires the return of

the original investment and the income that has accrued in the company, an associate

simply buys the shares at a price based on their asset backing. The company is not taxed

on the interest that accrues on the bonds (or is taxed at a very low rate) because it is

located in a tax haven (from the point of view of the residence country of the investor, it

is foreign-source income of a nonresident) and the investor is not taxable on the interest

because it accrues to the company and not to the investor.86 The investor will be taxable

in the residence country, if at all, only on the profit on the sale of the shares, but can

postpone this tax for many years by not selling. In any event, many developing and

transition countries do not tax gains on the sale of shares.

To counter this kind of activity, special rules are required in the domestic tax law

of the residence country, in effect to look through the company and tax the resident

investor on the underlying income. A number of industrial countries have such laws but

they are usually very complex. For developing and transition countries, a simpler

provision can be inserted in the tax law to give a discretion to tax and thus to send a

signal that such cases will be pursued when detected.87 A provision may be drafted along

the following lines:

1. Where a resident of *X* has entered into a transaction that converts income into

foreign-source income derived from a tax haven by another person, the tax

administration may adjust the income and foreign tax credit position of the

resident to reverse the tax effect of the transaction.

2. The tax administration may treat a foreign country as a tax haven if that

country has

(a) effective tax rates significantly lower than those of *X*; or

(b) laws providing for the secrecy of financial or corporate information that

facilitate the concealment of the identity of the real owner of any asset or

income.

This provision is not generally regarded as breaching tax treaty obligations in the

unlikely event that there is a treaty with the tax haven. There will still be an information

problem if such a provision is inserted into the law, and the investor will no doubt be

relying on lack of information as much as the interposing of the company to avoid tax. To

overcome this problem, it is necessary to have a question in the tax return or tax

declaration that requires the taxpayer to disclose investments in nonresident entities,

which will prompt the tax administration to inquire further. If the resident investor

deliberately answers this question incorrectly, as is likely, the taxpayer’s position is back

to tax fraud and problems of detection.

The information problem is almost impossible to solve. The tax haven will

usually not enter into tax treaties, or if it does, it will change the exchange-of-information

article so as not to require disclosure in relation to banks’ tax haven operations. As tax

treaties generally provide the only way for tax administrations in different countries to

exchange information, cooperation in the disclosure of the information from the tax

haven will not be forthcoming. For this reason and many others, developing and

transition countries should be wary of entering into tax treaties with tax havens. The best

that developing and transition countries can do for now to deal with capital flight to tax

havens is to try to remove the conditions that give rise to the flight in the first instance

and to apply severe penalties in relation to tax fraud involving tax havens.

**E. Change of Residence for Tax Reasons**

One other residence country tax problem can be noted in conclusion. Some

residents who anticipate deriving a substantial amount of foreign-source income may be

tempted to change their residence before the income is received so that it becomes

foreign-source income of a nonresident from the point of view of the former residence

country. Obviously the change would be made to a country that would not tax the income

(possibly a tax haven) and would occur only if there were no substantial source country

tax on the income (because otherwise the residual residence country taxation is likely to

be minor). Some industrial countries have special rules to deal with this problem, but they

may be regarded as unnecessary for developing or transition countries. The main problem

for such countries is in fact likely to be the other way around, that is, the rules of

industrial countries in this area may create problems for expatriate taxpayers who become

residents. The rules outlined above to deal with the tax problems of expatriates may also

assist in overcoming this problem.88

**VII. Taxation of Nonresidents**

As already noted, general principles suggest that the income of nonresidents

should be taxed on a flat-rate basis, as progression is a matter for the residence country.

In practice, some taxes on nonresidents are collected on a flat-rate basis, but more for

administrative convenience than principle. Because of the general rule found in most

legal systems that one country will not assist another in enforcing its tax laws and

because of the general administrative difficulties of dealing with persons and assets

outside a country, the source country will be well advised to enforce its tax claim on the

payer of the income before the payment leaves the country in cases where the recipient

does not have any substantial connection with the country, such as a permanent

establishment. Hence, it has become accepted as a general principle of international

taxation that taxation of passive income unconnected with a business in a country is

enforced by flat-rate final withholding taxes, whereas tax on business income arising

from a permanent establishment is levied on net income and is collected by the normal

assessment system applied to businesses of residents (which may also include some

elements of withholding and payment of tax by installments).

For other forms of income, there is less consistency in practice between flat-rate

withholding and tax by assessment, although where assessment is used it is normally in

accordance with the rate scale applicable to residents, rather than with a special flat-rate

scale for nonresidents (although personal allowances including a tax free amount are

often confined to residents). The discussion of taxation of nonresidents will thus start

with the related issues of tax rates, method of collection, the use or not of assessments,

and the effect of tax treaties, taking the categories of income in turn as for the source

area. It will then turn to a number of other issues affecting nonresidents of concern to

developing and transition countries.

**A. Income from Immovable Property**

Income of nonresidents from immovable property is taxed by some countries on a

flat-rate final withholding basis on gross rent and by others on an assessment basis. Some

countries provide an option to nonresident taxpayers as to the method of taxation89 since,

although final withholding is simple, it can prove very rough and ready because of the

wide variation that occurs in the amount of deductions relating to income from

immovable property (e.g., the full amount to purchase the property, or none of it, may

have been borrowed, leading to very different amounts of interest deductions). As

enforcement in this case is not generally a problem (assuming that the tax administration

can execute against the immovable property for unpaid tax), tax by assessment on a net

basis seems the fairer approach, and requiring private residential tenants to withhold on

rental payments is unlikely to be enforced effectively. Tax treaties do not generally

constrain domestic law in this case.