**International Aspects of Income Tax**

**The International Dimension of Taxation**

In the development of a country’s tax laws, the international dimension plays an

increasingly important role that significantly restricts the rules that might be adopted if

regard were had only to domestic considerations. The increasing role of international factors

is mainly attributable to the globalization of the world economy.

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**A. Importance of International Taxation**

International trade has existed since the birth of nations, but there has been an

accelerating growth not only in trade but also in finance and investment since the end of

World War II. This growth has far outstripped the general growth in the world economy. One

important cause has been the gradual removal of barriers to international trade through the

various negotiating rounds of the General Agreement on Tariffs and Trade (the GATT, which

as of 1995 is administered by the World Trade Organization, or WTO). For finance, the

removal of exchange controls in most industrial countries, commencing from the floating of

exchange rates in the early 1970s, has been a notable factor leading to the globalization of

world capital and financial markets. The international organizations most involved here have

been the IMF and the Bank for International Settlements.

In relation to investment, the main multilateral push is yet to come. In recent years,

the foreign direct investment laws of investee countries and the investment rules for various

institutional investors in investor countries have been liberalized and bilateral investment

treaties have grown. The Multilateral Agreement on Investment is currently under

negotiation in the OECD. When this treaty is concluded in the near future, it is proposed to

extend its regime worldwide through the cooperative efforts of the OECD and the WTO,

which will see further global relaxation of investment controls. In addition, the end of the

cold war has freed up the international transfer of technology, and labor is also becoming

more mobile, especially for high-cost services (such as professional, management, and

consulting services) and within trade blocs.

Overlaying all these developments and substantially contributing to many of them are

the great advances in international communications and computer technology.

It is a corollary of this growth in international transactions that international tax laws

(along with international trade, finance, and commercial laws) have become more significant

to each country’s legal system. Moreover, as restrictions in other areas are reduced or

removed, taxation is brought increasingly into focus, but there is a significant difference in

the tax case. Whereas it may be possible to liberalize or abolish rules in other areas affecting

international transactions, taxation needs to be retained in some form for the financing of

governments. The international challenge for taxation is the development of a system that

does not act as an undue impediment to international transactions while protecting the

revenue of each state.

Although this challenge is present for all kinds of taxes, this chapter deals with the

income tax.5 The income tax is usually the major source of revenue and the most complex tax

in industrial countries. For both these reasons, the tax causes the most problems in the

international arena. In developing and transition countries, the income tax may not be the

most important tax in terms of revenue, but it is looked to as serving that role in the future

and it will also generally be the tax of greatest concern to foreign investors and expatriate

personnel.

**B. The Challenge for International Taxation**

There are two main categories of case that international tax rules have to deal with.

First, there is the taxation of persons from outside a country who work, enter into

transactions, or have property or income in the country. Second, there is taxation of persons

who belong to a country and work, enter into transactions, or have property or income

abroad. The usual term used in international taxation to denote the concept of a person’s

belonging to a country is “residence” (“resident” and “nonresident” being used to indicate

whether a particular person belongs to a country or not); similarly the usual term for income

arising in a particular place is “source” (“domestic” and “foreign” being used to indicate

whether particular income is sourced inside or outside a country).

The two categories arise in virtually all areas and types of taxation. For the income

tax, the issues are the taxation of domestic income of nonresidents and the taxation of foreign

income of residents. In both categories of case, the main problem is the potential for double

taxation or double nontaxation of the income. That is, more than one country may seek to tax

without reference to tax levied in another country, or no country may tax (usually on the

assumption that another country is taxing, although often it will be the result of the increased

opportunities for tax planning or tax cheating on the part of taxpayers that international

transactions offer). Double taxation is likely to act as a barrier to international transactions,

and the nations of the world are generally agreed on the desirability of removing such

barriers as a means of increasing global welfare.

By similar reasoning, double nontaxation of international transactions will create a

bias in favor of international over domestic transactions, leading to a loss of global (and

national) welfare, not to mention tax revenue. While, however, there is general agreement

among taxpayers and governments on the undesirability of double taxation, double

nontaxation is obviously desired by taxpayers and to some extent tolerated or even

encouraged by governments. Developing countries often express the view that any increase

in global welfare arising from the removal of international barriers accrues mainly to

industrial countries. International agreements sometimes contain special regimes to deal with

these concerns of developing countries, such as the generalized system of preferences in the

GATT, which allows industrial countries to confer tariff privileges on developing countries

without being obliged to extend them to all GATT members.

In the income tax field, this developing country view finds expression in the desire to

offer tax incentives to international investors in order to attract capital and to ensure that the

tax systems of industrial countries do not negate the effect of the incentives by collecting the

tax that the developing countries have given up. The desired result of developing countries is

generally achieved by tax sparing provisions in bilateral tax treaties, which effectively

sanction double nontaxation and hence create a bias in favor of international investment in

developing countries. This particular policy in favor of double nontaxation is dealt with

elsewhere in this volume.6 In this chapter, the general premise is that the basic goal of the

international income tax system is to avoid double taxation and double nontaxation.

**C. Consensus on International Tax Rules**

As the importance of the international dimension of income taxation has grown, an

international consensus has emerged about the structure of the international income tax

regime. The income tax is typically levied by a country on (1) the domestic and foreign

income of its residents and (2) the domestic income of nonresidents. These basic rules are

referred to respectively as the residence and source principles of taxation. The tax legislation

of a country should in succinct terms state in some suitably conspicuous place (either the

general provision levying the income tax, or the beginning of the group of provisions dealing

with international issues, or both) whether and to what extent it has adopted these rules.

If a resident of one country earns income from a source in another country, double

taxation is likely to result because one country will tax that income on a source basis and the

other country on a residence basis. In this case, the internationally accepted regime is that the

source country has the prior right to tax (although this right may be limited by treaty), and the

residence country is responsible for relieving any double taxation that results. Such relief is

generally achieved through one of two systems, the exemption system whereby the foreign

income is exempted from tax in the residence country, and the foreign tax credit system

whereby the tax of the residence country on the foreign income is reduced by the amount of

source country tax on the income. Most countries employ some combination of the two

systems.

The details of the rules necessary to implement these apparently simple concepts and

their interaction with tax treaties will take up the remainder of this chapter. Before embarking

on these rules, I will explore briefly the structure, purpose, and effect of tax treaties.

**III. Tax Treaties**

Tax treaties (also often referred to as double taxation conventions or double tax

agreements) are international agreements entered into by countries and hence subject to

general international law on treaties as codified in the Vienna Convention on the Law of

Treaties.7 Most tax treaties are bilateral, that is, involve two countries only, and cover income

and capital taxes, though there are some examples of multilateral tax treaties. There are well

in excess of 1,000 tax treaties and the number is growing rapidly.8

**A. Structure of Tax Treaties**

The history of tax treaties can be traced to the League of Nations, which was pressed

to deal with the problem of double taxation after income taxes became important during the

First World War and which developed a number of models for use in negotiation of bilateral

tax treaties.9 The major modern successor to these models is the OECD Model Tax

Convention on Income and on Capital (the OECD Model), which itself has gone through

various versions.10 Of especial interest to developing and transition countries is the 1980 UN

Model Double Taxation Convention (the UN Model), which was based on the 1977 OECD

Model but designed to take into account the special interests of developing countries.11

The typical structure of tax treaties is most easily seen from the chapter and article

headings of the OECD Model as follows:

Chapter I Scope of the Convention

Article 1 Persons covered

Article 2 Taxes covered

Chapter II Definitions

Article 3 General definitions

Article 4 Resident

Article 5 Permanent establishment

Chapter III Taxation of income

Article 6 Income from immovable property

Article 7 Business profits

Article 8 Shipping, inland waterways transport, and air transport

Article 9 Associated enterprises

Article 10 Dividends

Article 11 Interest

Article 12 Royalties

Article 13 Capital gains

Article 14 Independent personal services

Article 15 Dependent personal services

Article 16 Directors’ fees

Article 17 Artistes and sportsmen

Article 18 Pensions

Article 19 Government service

Article 20 Students

Article 21 Other income

Chapter IV Taxation of capital

Article 22 Capital

Chapter V Methods for elimination of double taxation

Article 23A Exemption method

Article 23B Credit method

Chapter VI Special provisions

Article 24 Nondiscrimination

Article 25 Mutual agreement procedure

Article 26 Exchange of information

Article 27 Members of diplomatic missions and consular posts

Article 28 Territorial extension

Chapter VII Final provisions

Article 29 Entry into force

Article 30 Termination

This structure (and even the numbering) is followed with only a few variations in

nearly all existing tax treaties. The treaties apply to income and capital taxes12 levied on

residents of either of the countries that are parties to the treaty. Chapter III sets out the major

substantive rules of the model treaty; they operate by dividing income into classes and setting

out rules for each of the classes. These rules generally give the residence country an

unlimited right to tax the income and at the same time limit or eliminate the source country’s

right to tax, with the source country rights the greatest with respect to active income

(business, professions, and employment) and income from immovable property, and the least

with respect to passive income from intangibles. The treaty recognizes the source country’s

prior right to tax by requiring the residence country to relieve double taxation of its residents

for taxes levied by the source country in accordance with the treaty. Chapter VI deals with

administrative matters, to ensure that the treaty is effective in practice, and with the important

issue of nondiscrimination.

On the basis of these models and its own particular policies, each country generally

develops its own model that serves as the starting point in negotiations to conclude a tax

treaty with another country.13 A bilateral tax treaty takes about two years on average to

negotiate and bring into force. In view of this long period of gestation, most treaties fix a

minimum time period for their operation (generally about five years), but the expected life of

a treaty before replacement by an updated version will usually be of the order of 10–30 years.

This long life dictates both that the treaty be expressed in general terms so \_\_at it is flexible

enough to handle the inevitable changes in the domestic tax laws of the treaty partners which

will occur during the life of the treaty, and that the treaty contain mechanisms to deal with

issues which arise during its life (primarily through each party keeping the other informed of

changes in tax laws and through the consultative mechanisms provided by the mutual

agreement procedure).

**B. Purpose of Tax Treaties**

The purpose of bilateral tax treaties is typically expressed in their preamble to be “the

avoidance of double taxation and the prevention of fiscal evasion.”14 As most countries

contain within their domestic law provisions to prevent double taxation of their residents in

the most common case (where another country taxes the same income on a source basis), the

main operation of tax treaties in this respect is for other types of double taxation that can

arise as elaborated below. The prevention of fiscal evasion primarily refers to cases where

taxpayers fraudulently conceal income in an international setting and rely on the inability of

tax administrations to obtain information from abroad. The exchange of information article in

tax treaties is the major provision dealing with this problem. Because of the capital flight

experienced by many developing and transition countries, exchange of information is

important, but in practice there are some considerable hurdles to successful exchange for

reasons developed below.

From the perspective of developing and transition countries, there are a number of

other purposes of tax treaties that are usually unstated but in many cases are more important.

First, there is the division of tax revenues to be derived from income involving the two

countries that are parties to the treaty. Where flows of income from business and investment

are balanced between two countries, or even among a group of countries, it often does not

make a large difference if each country agrees to significantly curtail its source jurisdiction to

tax, as its residence taxation of income sourced in the other country is correspondingly

increased. Where the flows are substantially unbalanced, the conclusion of a treaty under

which each country gives up some of its source jurisdiction to tax generally has the effect of

transferring revenue from one country to the other. Typically, developing and transition

countries (and many smaller industrial countries) will be in the position vis-à-vis industrial

countries of substantial net capital importers and hence will want to preserve source country

tax rights.

Second, developing and transition countries nowadays generally desire to encourage

capital inflows from capital-exporting countries. Tax treaties may facilitate this process in a

number of ways. In a very general sense, entering into tax treaties acts as a signal that a

country is willing to adopt the international norms. This symbolic function is reinforced by

the nondiscrimination article of tax treaties, by which the country undertakes not to

discriminate under its tax laws against residents of treaty partners. Many potential investors

attach great importance to the nondiscrimination article, in light of the historical antipathy

that many developing and transition countries have in the past exhibited to inward

investment. It is no coincidence that many tax treaties with transition countries are

negotiated alongside investment protection treaties.

In the past, many developing countries took the view that they did not need tax

treaties.15 The countries very often adopted a policy that growth of their economies could

best be achieved through domestic production by domestically (often state) owned firms of

goods and services for domestic consumption. Hence, foreign investment was not needed and

economic policy bolstered the natural human emotional response against ownership by

foreigners. As tax treaties involved giving up part of the revenues from source taxation, there

seemed little to be gained from them. Likewise, it was a consequence of the domestic focus

that investment abroad by residents was not encouraged (a policy often enforced through

very strict exchange controls). This situation has now changed, as demonstrated by the

rapidly expanding tax treaty networks of many developing countries. Partly, the new attitude

is due to a policy shift that accepts the benefits that flow from international trade and, in

particular, from export-led growth in the model of the newly industrialized economies of

Asia. Another factor has been the practical impossibility of making exchange and investment

controls work effectively in a global economy.

Transition economies did enter into tax treaties in the past, but these were mainly

political gestures given that there were no significant capital flows from the West.16 The

provisions of the old treaties were often inappropriate for the new situation and they therefore

had to be speedily replaced (a phenomenon particularly noticeable in the case of the Russian

Federation). The need to do so, along with the large needs for capital, has spurred many

transition countries to develop their treaty networks in recent years. The tax laws of

transition countries are often not sufficiently developed or clear to enable the tax

administration to utilize treaty rules. For example, domestic legislation may lack rules for

adjusting transfer prices between related parties. This is another matter that the countries are

generally remedying.

The remainder of the discussion in this chapter therefore proceeds on the assumption

that most developing and transition countries will be actively pursuing the development of a

tax treaty network and that, in the case of the transition countries, changes will be made to

domestic law to remove the elements that form impediments to this development. What

effect does this assumption have on domestic law?

**C. Relationship of Tax Treaties and Domestic Law**

It is not necessary to incorporate into domestic law the contents of treaties that

operate only between states and do not directly affect private persons. A tax treaty, however,

is intended to confer enforceable rights on taxpayers against the countries that are parties to

the treaty. How this occurs is a matter for the constitutional law of each state, but in many

cases it is necessary for each country to carry out some formal law-making process, such as

approval of the tax treaty by parliament.

Further, the provisions of tax treaties are intended to have precedence over any

inconsistent provisions of domestic tax law. Again, how this is effected is a matter for the

constitutional law of the countries concerned. A common practice is to insert such a

provision either into the law giving effect to the treaty or into the domestic tax law itself.17

The usual result of such a provision under the law of most countries is that, apart from the

administrative treaty provisions on the mutual agreement procedure and the exchange of

information, a treaty sets limits on the operation of domestic law but does not expand its

operation.

Thus, if a country taxes business profits arising from sales to residents of the country

by a resident of another country without reference to a permanent establishment concept, the

business profits article of a tax treaty will usually prohibit such taxation, unless those profits

are attributable to a permanent establishment in the country. The outcome is the same if the

domestic law uses a permanent establishment concept, but the concept is wider than that used

in a relevant treaty. Similarly, if the tax applied under domestic law to dividends and interest

paid to a resident of the other treaty country exceeds the maximum rates permitted in the

treaty, the source state is obliged to reduce its taxation accordingly.

If, however, a country levies no tax on dividends or interest paid to nonresidents, then

the fact that a treaty allows such taxation up to a specified limit does not mean that such

dividends and interest are taxable. It is possible, however, for domestic law to provide that if

a treaty permits taxation that does not otherwise occur under domestic law, then the treaty

rule will become the domestic rule for this case. This is the position in France18 (and many

Francophone African countries under their tax legislation) and in Australia with respect to

source rules contained in treaties under legislation giving force to tax treaties.19 Such a result

is fairly uncommon, however.

By contrast, the administrative provisions of tax treaties (which may include articles

on mutual agreement, exchange of information, and assistance in collection) by their very

terms expand domestic law in the sense of giving powers that generally do not exist under

Model gives an avenue of recourse to challenge assessment to tax in certain cases that does

not exist under domestic law and overrides domestic limitation periods. Article 26 gives

power to exchange information that does not usually exist under domestic law and modifies

the secrecy provisions of domestic law accordingly.

The consequence of this relationship between tax treaties and domestic law suggests

an important guideline for drafting the domestic tax rules themselves. If the domestic rules

by and large follow the rules typically found in tax treaties, this will simplify the question of

the relationship between tax treaties and domestic law and provide transparency to foreign

investors as well as indicating (even in the absence of an extensive tax treaty network) the

intention of the country to adopt internationally accepted standards.20 This approach also

gives instant access to a substantial body of commentary that is accepted by international

consensus as elaborating and explaining the wording in question. The consequences of

following—or not following—this guideline will be explored below. Because an

international consensus exists on the structure and content of tax treaties, no one country,

except perhaps the United States, is able to depart substantially from international norms.

Accordingly, having a country tax treaty model that departs radically from the existing

international models and following that model in domestic law generally is not a viable

option for developing or transition countries.21 Moreover, no country can sensibly adopt a

policy of residence taxation only (i.e., excluding the source principle). Neither would it

make sense for developing and transition countries to adopt a policy of source-only taxation.

**IV. Definition of Residence**

Residence is almost invariably a central concept in the international tax rules of the

domestic tax law of a country, with residents taxed on their worldwide income (or at least

some categories of income).22 It is difficult to enter into tax treaties without a concept of

residence in domestic tax law because, by the first article of the international models, the tax

treaty applies to the residents of each country that is a party to the treaty and the definition of

resident in the treaty refers to a resident under the domestic tax law of the countries. The

basic idea behind the residence concept is that a person is a resident of a country if the person

has close economic and personal ties to the country. It is possible for a person to be a

resident of more than one country.

**A. Individuals**

Applying this basic policy idea in the case of an individual usually leads in domestic

tax legislation to the adoption of one or more of three approaches. First, there is a facts-andcircumstances

approach where no criterion is definitive but all the facts are weighed to

determine residence. In many countries, this approach is not specifically defined by statute,

and it is left to the courts or tax administration to give content to the concept. Tax treaties in

the article defining residence give an indication of the factors that are most often used for this

purpose: permanent home, personal and economic relations, and habitual abode. The

problem with this approach is its uncertainty, which can be ameliorated by combining it with

one of the following tests.

Second, the tax legislation may adopt rules for residence that are used for other

purposes in the civil law of the country concerned (such as entitlement to work or remain in

the country indefinitely under immigration laws, domicile, or citizenship). Many European

countries use domicile. The United States is the only major country that uses citizenship as a

residence-type test and, in view of the very liberal nationality laws of many countries, the

citizenship criterion does not seem appropriate in most cases.23 The problem with civil law

tests is that the policy underlying a test devised for other purposes may not be appropriate for

tax purposes, but the advantage is that they are more certain than the facts-and-circumstances

approach, unless the civil law concept itself is vague.

Third, a rule of thumb based on the number of days that a person spends in the

country during either the tax year or a moving 12-month period may be employed, the usual

period being half a year (expressed as 183 days or more). Under this test, physical presence

in the country for any part of a day usually counts as one day except when the person is in

transit between other destinations and does not pass the customs or immigration barrier.24

The advantage of using the tax year for this purpose compared with any moving 12-month

period that ends or begins in the tax year is that a person can determine residence in relation

to a particular tax year at the time of filing the tax return for that year. For example, if the

calendar year is the tax year and the due date for filing declarations is March 31, a person

who arrived in the country on October 1 will not know until the following October 1

whether the person was a resident from the time of arrival under a moving 12-month test.

The disadvantage of a rule that looks solely to the number of days of presence during the tax

year is that it effectively allows a person to remain in the country for up to 364 days

consecutively spread over two tax years without becoming a resident. An intermediate rule

that avoids these problems would look to presence in any consecutive 12-month period

ending in the tax year in question.

In either form, the test can be criticized as unfair because it is mechanical—one

individual can be treated as a resident despite very short periods of stay in the country (e.g.,

where a person drives to and from work through a neighboring country each work day),25

while others can manipulate their period of stay to avoid crossing the 183-day threshold even

when they are substantially connected to the country. Most countries use some variation of

the 183-day test but, because of its problems, often adopt a more substantive test of residence

in addition and enact other measures to ameliorate its arbitrary nature as discussed below.

Often, there is a special residence rule deeming specified government employees

stationed abroad to be residents. The main purpose is to ensure that the diplomatic or other

government staff of a country who may spend most of their working lives outside the country

are nonetheless resident and therefore taxable on their salaries by the country (as they will

often not be taxable in other countries, either by virtue of their diplomatic status or by virtue

of the government service article in tax treaties).

Under all tests, questions arise as to whether a person can be a resident for tax

purposes for part of the tax year and nonresident for part of the year. Most countries permit

this possibility mainly to cover the case of migration where a person is moving permanently

from one country to another. Where an individual is a resident for only part of a tax year, tax

allowances tied to residence are often apportioned.

Some language encompassing these possibilities (other than when reliance is placed on other

features of domestic civil law) follows.

1. Subject to 2. and 3., an individual is a resident of *X* for the entire tax year if

that individual

(a) has closer social and economic relationships with *X* during the tax year

than to any other country;

(b) is present in *X* for 183 days or more in any consecutive period of 12

months ending in the tax year; or

(c) is an official of the state service of *X* posted overseas during the tax year.

2. An individual who was not a resident in the preceding tax year shall not be

treated as a resident for the period preceding the day the individual was first present

in *X* during the tax year.

3. An individual who is not a resident in the following tax year shall not be

treated as a resident for the period following the last day on which the individual was

present in *X* during the tax year if during that period the individual had a closer social

and economic connection to a foreign country than to *X*.

4. For the purposes of 1(b),

(a) presence in *X* for part of a day is counted as a full day and

(b) presence in *X* without immigration clearance in transit between other

countries is disregarded.

Some countries distinguish varying degrees of residence, such as residence and

permanent residence, for different purposes under domestic tax law.26 This approach may

create confusion in the operation of the law unless the different terms are used with care in

drafting. It can also cause problems in the application of the tax treaty article defining

residence. Countries with a number of residence concepts need to review their model tax

treaty to ensure that it is in harmony with the domestic tax law. Generally, it is better to avoid

the use of differing residence concepts in the law and to deal with the concerns that give rise

to them in other ways (such as special rules for expatriates; see section V(B) of this chapter).

Because countries use different tests of residence, individuals with dual residence are

not uncommon. In fact, even if all countries adopted the most common definition of

residence, namely the 183-day test, it would still be possible for the same individual to be

resident in more than one country under each country’s tax law at the same time. An example

is the frontier worker who lives in one country but works in another and crosses the border

between the two countries each work day. Dual residence creates problems of double

taxation where each country taxes the worldwide income of its residents. The mechanisms

for giving relief for double taxation arising from combined source and residence taxation of

the same income are not able to solve this problem (sometimes called residence-residence

double taxation). It is difficult for a country to solve this problem on its own, and so tax

treaties provide a tiebreaker mechanism to allocate the residence of the individual to one

country alone for the purposes of the treaty. This allocation is achieved through a hierarchy

of tests involving the individual’s permanent home, center of personal and economic

relations, habitual abode, and nationality.27

For frontier workers, this mechanism may not solve the practical difficulties that

average people face in being subject to two tax jurisdictions (either because a taxpayer is

resident in one country and receives income sourced in the other country where the

taxpayer’s employment is conducted, or because the taxpayer is regarded as a resident of

both countries). Accordingly, tax treaties between contiguous countries often contain

provisions to ensure that frontier workers are taxed on their wages in one of the countries

alone.

**B. Legal Entities**

The residence of other taxpayers besides individuals, that is, corporations and other

entities taxed as separate taxpayers, involves similar problems. From a policy perspective,

legal entities are ultimately owned by individuals and the residence of the owners should

determine the residence of the entity. This is not a practical test for a number of reasons: it

may be necessary to trace ownership through many tiers of entities, which is not

administratively feasible, and in any event the ultimate owners may themselves be resident in

different countries. Hence, a number of other tests are used. The first test is the country under

whose laws the entity came into existence, commonly referred to as the place-ofincorporation

test. Even more than the 183-day rule, this test is quite mechanistic and

susceptible to manipulation. Therefore, additional tests and other safeguarding mechanisms

are often provided.29

The second test is usually based on the place of management of the legal entity. In

Anglo-Saxon countries, this is often expressed in the phrase “central management and

control,” which basically means where the board of directors meets. European countries look

to the location of the head office of the legal entity.30 These tests are based in part on a factsand-

circumstances approach to residence and so are not quite as mechanistic as the place-ofincorporation

test, but they are susceptible to manipulation nevertheless.

Tax treaties seek to deal with the problem of dual residence of legal entities as for

individuals, but are much less successful in this area mainly because there is no real

international consensus on the appropriate tiebreaker, even though the OECD Model uses the

place of effective management.31 Moreover, dual-resident companies can give rise to

problems that are not adequately addressed in tax treaties, especially the double claiming of

deductions on a residence basis. Hence, a number of countries have enacted rules denying

deductions to dual-resident companies in certain cases.32 For developing and transition

countries, it may be better to rely on general antiavoidance rules to deal with this kind of tax

planning, as discussed below.33

These problems by no means exhaust the issues regarding residence of entities. Most

countries have a variety of legal entities, not all of which can be easily fitted into the category

of company or corporation for domestic tax law and tax treaty purposes. As exotic entities

are being used increasingly in international tax planning,34 countries should consider the need

for special tax residence rules for various kinds of entities. Further, if it is not regarded as

clear from definitions based on the above criteria that governments (central, regional or local)

and other public bodies of a country are resident in the country, then provision may be made

to that effect.

It is common to define both individuals and legal entities that are not resident under

the definitions in the domestic law as nonresidents for the purposes of the law,35 although

this may simply be stating the obvious.

**V. Definition of Source of Income**

Residence establishes a relationship between a country and the taxpayer deriving the

income, whereas source concerns the connection between the income itself and a country.

The basic policy idea is that income should be sourced in the country with which it has a

substantial economic connection. Obviously, income may often have substantial connections

with more than one country, in which case it may be appropriate to determine source by

apportioning the income between the countries. Source rules have traditionally used differing

concepts for active and passive income. In broad terms, active income is usually sourced by a

place-of-taxpayer-activity test, while passive income (where the taxpayer often engages in no

significant activity in deriving the income) is sourced by the place of activity of the person

paying the income. To the extent that a clear distinction can be drawn between active and

passive income, the growth of international trade in services raises questions as to whether

the place-of-taxpayer-activity test is always appropriate for active income.

**A. Geographical Extent of Country**

As source involves a geographic connection, it is necessary to define the geographical

area in question. For landlocked countries, this definition question does not present a real

problem because the land area of the country is the relevant area. For countries with a

maritime boundary, the territorial sea is treated under international law as part of the country

and the country’s jurisdiction also extends to the natural resources of the sea and seabed of

the continental shelf. It is customary to extend source tax jurisdiction to the continental shelf.

This extension may be effected in a way that reflects the limited rights that a country can

exercise over the continental shelf (i.e., the country taxes only those continental-shelf

activities over which it has sovereignty) or may be more general and cover all activities on

the continental shelf. The resulting difference in tax jurisdiction over the continental shelf is

shown by the example of a floating hotel owned by a nonresident and moored on the

continental shelf; if the tax jurisdiction of a country is limited by reference to its sovereign

powers under international law, the country cannot tax the profits of the hotel, whereas it can

tax the profits if the broader formulation is adopted.

It is common to include a similar provision in tax treaties in the definition article.

Given the importance of potential oil or gas resources in the continental shelf, oil-producing

countries commonly include in tax treaties special provisions on this topic that preserve

source country jurisdiction as far as possible. In the case of other resources of the continental

shelf, such as fisheries, some developing countries levy license fees in lieu of income tax,

although in either case there are significant enforcement problems.

There is no agreement in international law that countries must limit their taxing

jurisdiction for nonresidents to income sourced in the country. Some international lawyers

consider that a country can assert the right to tax everybody in the world on their worldwide

income,36 but it will never be able to enforce such a claim and may attract various forms of

retaliation from other countries. In other words, the adoption of the residence and source

principles of taxation has been very much guided by practical considerations of enforcement

and reciprocity. In marginal cases, such as floating hotels moored on the continental shelf, an

assertion of tax jurisdiction is not likely to cause any problems practically or in international

relations.

**B. Structure of Source Rules**

Many industrial countries do not have elaborate source rules in their domestic tax

laws,37 instead relying on such general expressions as income arising (from activities) in the

country to express the source concept. In these countries, there will usually be a welldeveloped

body of practice as to the detailed application of the general principle,38 and in

any event, there will be an extensive network of tax treaties in place containing explicit and

implicit source rules for virtually all types of income. In the past, it was possible for

developing countries to elaborate their domestic tax laws without detailed source rules, both

because international income tax was not as important for the reasons outlined above and

because the countries could usually rely on the body of practice in industrial countries

because their tax laws would usually be modeled on the law of one or other industrial

country. Transition countries are in all cases actively encouraging foreign investment.

However, there is no tax tradition and in most cases no tax treaty network on which they can

call to fill in the gaps in their laws on sourcing rules. For both developing and transition

countries, fairly detailed source rules will give comfort to foreign investors as to when their

income will or will not be taxed.39

Tax treaties contain only a few source rules explicitly identified as such, for example,

article 11(5) of the OECD Model dealing with interest. Nonetheless, for most kinds of

income, there are implicit source rules. The source rule is implied by the way in which a

country is given jurisdiction to tax income derived by residents of the other treaty country;

for example, in the case of business income, under article 7 a country can tax income only if

attributable to a permanent establishment in that country of a resident of the other treaty

country. Some countries include a provision in their tax treaties to make clear that these

implicit rules are effectively the source rules under the treaty.40

Countries can appropriately take these implicit treaty rules as the basic guideline for

their source rules, subject to some caveats. First, in order to give the country negotiating

room in the tax treaty process, the source rules in the domestic law should generally be more

expansive than those found in treaties. Second (a related point), as the treaty rules operate to

divide revenues between source and residence country, the source country will usually want

in its domestic law to take full advantage of its taxing powers and have broader rules than

those found in treaties. Third, the rules in tax treaties are to some extent shaped by practical

considerations of tax administration, with a country giving up taxing rights not because

income cannot be regarded as sourced there but because it is simpler for taxpayer and tax

administration not to attempt to tax the income. However, it is very helpful if the domestic

law generally follows the categorization of income that occurs in tax treaties because this

makes the interaction of domestic law and tax treaties easier to understand. It also allows an

easy connection between the type of income, and the method of taxation and collection of

tax, as outlined below.

Just as it is possible to have residence-source and residence-residence double

taxation, so source-source double taxation can arise when more than one country asserts that

the same income is sourced in each country.41 Again, it is difficult for any one country to

solve this problem unilaterally, and tax treaties are the usual mechanism for resolving it. The

method adopted in treaties is to specify expressly or impliedly for a single source rule to

apply between the parties to the treaty for particular categories of income.42 In turn, this

method creates some impulse for countries to adopt similar rules in their domestic laws as

informal harmonization on the same approach will generally overcome source-source double

taxation even without tax treaties. Against this background, the various categories of income

are now considered basically in the same order as found in tax treaties.

**C. Income from Immovable Property**

For income from immovable property, such as the rental of buildings or mineral

royalties, the income is sourced in the country where the property is situated, whether it is

derived as part of a business or otherwise. Under tax treaties, the provisions based on article

6 of the OECD Model include income from agriculture and forestry in this category and have

a fairly extensive definition of immovable property that includes reference to the domestic

law concept of immovable property. These features can be incorporated in domestic law,

although it is probably simpler to omit them. Their effect in practice is not significant.

**D. Business Income**

For business income, tax treaties start with the permanent establishment concept,

which refers to a relatively enduring presence in a country whether by way of location (e.g.,

an office) or personnel. The definition article of this term is quite lengthy and can be

simplified in domestic law by removing some of the qualifications that limit the concept.

Further, some extensions of the concept found in the UN Model may be added, especially as

room in the tax treaty process. Special rules on oil and mineral exploration activities may

also be appropriate for some countries. A provision with these features could take the

following form:

1. A permanent establishment is a fixed place of business through which the

business of a person is wholly or partly carried on.

2. A permanent establishment also includes

(a) a building site or construction, installation or assembly project in the

country, or supervisory activities connected therewith; and

(b) an installation or structure used for the exploration or exploitation of

natural resources in the country, or supervisory activities connected

therewith.

3. Where another person is acting on behalf of the person and has, and habitually

exercises, in a country an authority to conclude contracts in the name of the

person, that person shall be deemed to have a permanent establishment in that

country in respect of any activities which that other person undertakes for the

person. This paragraph does not apply to an independent agent acting in the

ordinary course of business.

The primary sourcing rule for taxing business income will then be through association

with a permanent establishment. In addition to the OECD Model and the UN Model tests of

connection, many countries also tax technical, administrative, and management fees paid to a

nonresident by an enterprise that is resident in the country or that constitutes a permanent

establishment of a nonresident in the country. Such a rule deals with cases where persons use

deductible service fees to reduce the tax base in the country of the paying enterprise without

corresponding taxation by that country of the fees received by the nonresident (which will

often be a company that is related to the payer).43 Alternatively, management and service fees

may be taxed as royalties, which will usually be the preferable course. A suggested provision

incorporating the UN features, but not technical etc. fees, follows:

Business income is sourced in country *X* if

(a) it is attributable to a permanent establishment of the taxpayer in *X*;

(b) it arises from sales by the taxpayer in *X* where the taxpayer has a

permanent establishment through which goods of the same or similar kind are

sold; or

(c) it arises from other business activities carried on by the taxpayer in *X*

where the taxpayer has a permanent establishment through which activities of

the same or similar kind are carried on.

This provision will not exhaust the taxation of business income. First, there will often

be special provisions for specific types of business income that take precedence over this

general rule. Second, income of certain types that may or may not be income of a business

depending on the circumstances (especially passive income, such as dividends, interest,

royalties, or capital gains) will generally be taxable if it falls into either the business income

rule or into the specific rules for the type of income in question (although the method of

taxation will vary for each case as explained below).

Thus, tax treaties have special rules for international transport income, independent

professional services, and income from entertainment and sporting activities. Many countries

also add income from international communications and insurance. The OECD tax treaty

approach for international transport income is premised on the view that the income will be

equally balanced between the two countries, so that it is simpler from an administrative point

of view to confine taxation to the country of residence of the company carrying out the

international transport.44 In the case of air transport, this assumption will generally be correct

because of the restrictions in international airline agreements entered into by governments,

which try to share revenues between the airlines of each country, while for shipping very few

countries nowadays have substantial shipping industries because of the way that business is

organized internationally. While the tax treaty approach thus does little harm, some countries

find it easier to use a simple 50/50 rule that divides the income equally between the start and

end points of the international transport, an approach also used for international

telecommunications income (not separately covered in tax treaties partly because of its recent

development and partly because international agreements between countries often share the

income between companies in each country).

Professional services income nowadays is generally regarded as the same as business

income, and the existence of separate articles in tax treaties is mainly to be explained

historically.45 As the outcome under such articles is similar to that for business income

generally, special sourcing rules for such income are not often included in domestic law,

except where it is intended to include a time threshold, which is discussed below in relation

to employment income.

The taxation of insurance is a very specialized topic. Because of the difficulties

involved in calculating the profit of an insurance company, some countries simply levy tax

on a percentage of the premium income, either generally or specifically for certain types of

insurance or in the international area. The basic sourcing rule adopted is the insuring of risks

located in a country.

Business (and employment) income from entertainment and sporting activities is

sourced in a country when the activity is carried out there; this is because very high incomes

can be earned in short periods within a country that may not be captured under the general

business income rules.

When special sourcing rules are adopted for particular types of business income in

domestic law, they override the general business income source rule. In turn, tax treaties will

generally overturn the special rules for insurance and telecommunication income and adopt

the general business income rule unless the special rules are preserved by provisions inserted

for that purpose (which does occur in bilateral treaties and the UN Model for insurance but

not for telecommunications). Dividends, interest, and royalties are often regarded as passive

income but may be received in a business context, in which event the rules for taxing

business income generally apply.

**E. Dividends, Interest, and Royalties**

Dividends are usually sourced under domestic law, and tax treaties by the residence

of the company paying them. Interest under tax treaties also uses a basic residence of the

payer criterion,46 but where the interest is borne by the permanent establishment in

connection with which the indebtedness is incurred, the interest is sourced by the location of

the permanent establishment. Taken together, these rules on interest mean effectively that it

is the place where the economic activity giving rise to the payment of the interest occurs that

is its source.47 Interest source rules under domestic laws show some variation from this

pattern, most commonly adding the case where the interest relates to a loan that is secured by

property situated in the country, but tax treaties generally override this rule. The tax treaty

rule for the source of interest differs in one respect from the rule suggested in the text,

the residence of the debtor occurs only where the branch is in one of the treaty countries;

otherwise, the residence of the debtor prevails. This treaty rule can give rise to difficulties

and is thus not followed by some countries in their treaties.48

Royalties do not have a detailed source rule in the OECD Model, given that taxation

is exclusively reserved to the residence country, but almost half of the OECD countries and

the UN Model do not follow this pattern. Rather, they replicate the interest source rule for

royalties, that is, residence of the payer with the permanent establishment qualification. The

United States has a sourcing rule of where the property giving rise to the royalties is used49

and can usually have this accepted in its treaties, but less powerful countries may find it more

difficult to go their own way. Certainly, domestic law should contain a clear rule for sourcing

royalties, as they are one of the most important forms of income internationally—especially

so in a world that is coming to be dominated by trade in technological innovation and

services rather than goods.

One of the most important aspects of the source rules for dividends, interest, and

royalties is the definition of the terms. Most domestic tax laws will have a definition of

dividend in relation to the general rules for taxing distributions by legal entities,50 and tax

treaties effectively adopt this definition. The reliance on the domestic definition of dividend

under tax treaties can cause difficulties, as countries have widely differing definitions, which

can lead to the consequence that one country regards a payment as a dividend whereas

another country regards it as something else. For example, one country may treat a payment

on the liquidation of a company to its shareholders as, in whole or in part, a dividend,

whereas another country may treat it as a disposal of the shares (and so covered by the capital

gain article in tax treaties). Tax treaties do not usually provide any clear resolution of this

“conflict-of-qualifications” problem, except the possibility of the mutual agreement

procedure. It follows that whatever definition of dividend is adopted for domestic purposes,

problem cases can arise internationally under tax treaties. No simple solution is available.

By contrast, the definitions of “interest” and “royalties” in tax treaties do not rely on

domestic definitions. The definition of interest in the OECD Model is income from a debt

claim (but excluding penalty charges for late payment). While this definition operates clearly

in many cases, financial innovation in recent decades has given rise to many instruments that

are effectively loans but that do not relate to a debt claim and are therefore outside the

definition (e.g., foreign exchange contracts and swaps can be structured to produce interest

equivalents). Increasingly, countries are moving in their domestic laws to ensure that such

instruments are taxed consistently with interest, but the rules required for such a regime are

likely to be very complex. The result is that what is assimilated to interest under domestic

laws varies greatly among countries and the definition used will depend on a number of

fundamental policy choices in the taxation of interest.51

The definition of royalties is more straightforward. The essence of the definition in

tax treaties, which is followed in the domestic law of many countries, is a payment for the

use of intellectual property, including copyrights, patents, know-how, and secret processes.

(The term “royalty” is also commonly used for payments to the owner of land or to the state

for the right to extract natural resources, but these are income from immovable property and

have already been dealt with above.) The OECD Model before 1992 covered equipment

rentals in the definition of royalties by including payments for the right to use industrial,

commercial, or scientific equipment; the deletion of this item in a bilateral treaty means that

equipment rentals come within the business profits article under tax treaties. While the usage

covering equipment leasing probably extends beyond the normal understanding of the term

royalties, many countries still include equipment rentals in their domestic law definition of

royalty.52 As long as positive tax rates are specified for interest and royalties in tax treaties

(not the case in the OECD Model but not uncommon in practice), one justification for this

inclusion is that interest can be converted into rental income through the device of the

financial lease (i.e., a lease that is the equivalent of a loan), but the treatment under the

domestic law and tax treaties will effectively be the same.53

One problem of the royalty definition in the OECD Model is the reference to

payments “for the use of, or the right to use” patents etc. This language apparently does not

cover disposals of intellectual property and, if so, the royalty definition can be simply

avoided as transactions for use can easily be converted into disposal transactions because of

the flexibility of patent and copyright law in most countries. For example, a person could be

given the right to use a patent in a particular country for a specific period of time in return for

payments related to the number of items produced using the patented process, or the patent

could be disposed of to the person in respect of that country and time period on the same

payment terms. For this reason some countries provide that where some proportion of the

payments in relation to intellectual property are contingent on use, then they will be treated

as royalties even though the transaction takes the form of a disposal.54

In some countries, technical fees are assimilated into the definition of royalties or are

taxed similarly to royalties.55 In the context of tax treaties, similar issues arise. Payments for

technical services and the like may be incorporated into the royalties article or subject to a

separate but similar article.56 If no such provision is made, then the domestic rules for taxing

such income will be overridden by tax treaties.

**F. Capital Gains**

Capital gains are another area where variation in domestic laws can give rise to

problems in their international treatment. Some countries (especially common law countries)

have a general conception of capital gains as any gain on an asset other than inventory (and

similar property) of a business and personal use assets of an individual (such as consumer

durables). Within this group, a number of countries do not tax such capital gains while many

others have beneficial rules and tax rates for them. Other countries, especially those based on

civil law, have either a much narrower concept of capital gains or no such concept—business

profits are taxed with no tax distinction drawn between gains on disposition of inventory and

other assets, and individuals are simply taxed on gains on a list of assets without invoking

any rubric of capital gain in either case.57 Hence, the use of the term “capital gains” can cause

some confusion in an international setting and it can be argued that it is better avoided even

though it is used in the OECD Model.58

Following the tax treaty rules, gains on business assets are generally sourced at the

permanent establishment to which the gain is attributable; gains on immovable property are

sourced where the property is situated; and gains on other property are sourced where the

person disposing of it is resident. A number of countries include special rules in their

domestic law and tax treaties for sourcing gains on shares in resident companies in one or

more of the following categories: companies whose major assets are immovable property,

direct investment interests in companies (usually defined as a certain proportion of the

shares, such as 10 percent or 25 percent) and, more rarely, any interest in a closely held

company.59 The first two of these are intended to buttress the rules on taxing gains on

business assets and immovable property. A taxpayer can easily avoid those rules by holding

the relevant assets in a company and then selling the shares in the company.

While the purpose of the rules on companies is understandable, in practice it is not

possible to prevent nonresidents from using variations on the same stratagem to avoid these

rules. Rather than selling the shares in the resident company directly holding the relevant

assets, a taxpayer can hold the assets through several tiers of companies (usually located in

tax havens); it is then possible for one higher-tier nonresident company to sell the shares in

the nonresident company below it in the tier and so effectively dispose of assets that may be

several tiers below. While domestic law can have rules referring to disposal of shares in

companies that amount indirectly to disposal of the relevant assets,60 such rules will be

almost impossible to enforce and will usually be overridden to a greater or lesser degree by

tax treaties.

**G. Employment, Services, and Pension Income**

***1. Employment Income***

Employment income is usually sourced by the place where the employment is carried

out (and if it is carried out in several places, the income is apportioned between those places).

This is followed in tax treaties, with the exception that the OECD Model contains a 183-day

presence threshold before a nonresident employee is taxable, if employed by a nonresident

employer that does not deduct the relevant salary as part of the expenses of a permanent

establishment in the country. Some short time threshold, such as 30, 60, or 90 days, subject

to the same conditions, is a sensible rule for domestic law, as no country can successfully tax

such employees who are in the country for very short periods. Especially in the context of

developing and transition countries that are seeking to attract foreign investment, this kind of

rule allows the important exploratory visits to take place before investment decisions are

made without tax impediments so far as the employees of the potential investor are

concerned. A monetary threshold can also be used as an addition to the time threshold to

eliminate small amounts for ease of administration, or as an alternative to the time threshold

to try to capture very high amounts of income earned in a short period.61 Tax treaties contain

time limits for employment income, but not usually monetary limits.

***2. Fringe Benefits Tax***

Following the lead of Australia and New Zealand, a few developing and transition

countries have adopted fringe benefits taxes to deal with the problems of taxing benefits in

kind provided by an employer to an employee.62 The tax is levied directly on the employer at

a flat rate and the benefit is then tax exempt in the hands of the employee. Even from a

domestic viewpoint, the technical problems of this approach to the fringe benefits problem

indicate that the tax should be adopted only when it is politically the only possible way to

ensure that the benefits are taxed.63 Otherwise, the more straightforward method of treating

fringe benefits as the equivalent of cash wages is to be preferred.

From an international perspective, fringe benefits taxes cause significant problems.

First, the application of the residence and source principles to the tax is unclear. Does the

residence of the employer or the employee count? Is the sourcing rule the same as for wages?

If so, one of the claimed advantages of the tax, the avoidance of allocating benefits to

individual employees, is lost. Second, how is relief from double taxation effected in domestic

law (especially as other countries may not be using the tax, but taxing employees instead)?

At the moment, fringe benefits taxes often lack mechanisms to avoid double taxation. Third,

no satisfactory tax treaty mechanism has yet been found for dealing with such taxes.64

Where the traditional approach of taxing fringe benefits to the employee is adopted, tax

treaties experience little difficulty as the matter is dealt with by the employment income

article.

For developing and transition countries, this fringe benefits tax problem is more than

theoretical. As already noted, the taxation of the salaries and benefits of expatriate employees

of foreign investors can be a significant factor in investment decisions. If a fringe benefits tax

is adopted, it will not be relieved in the country of the expatriate employees’ residence if that

country applies a foreign tax credit, with resulting double taxation. The foreign investor,

rather than the employees, in practice will absorb the fringe benefits tax so that it is simply an

additional cost of—and disincentive to—the investment. Given that fringe benefits for good

reasons often figure importantly in the remuneration packages of expatriate employees, the

cost can become significant. Indeed, even under the traditional approach to fringe benefits,

there is an argument for special rules to deal with such employees. Carrying these rules over

into a fringe benefits tax will ameliorate but not solve the problem that the fringe benefits tax

causes in the international context.

***3. Services Income***

The employment income source rule is often extended to all forms of services

income. This has two effects. First, not only is the employee taxable but also the employer,

where the services of the employee are part of the rendering of services of the employer to a

third party. Second, in the case of professional services and services with a high value added

where no employment is involved, the person rendering the services is taxable without the

need for some permanent presence as is generally true for business income. Because of the

increasing significance of high-cost services in international trade, it is sensible for countries

to seek to tax such services. They can do this either by adopting a general rule for services

based on the place of performance or by including the rendering of services other than as an

employee in the definition of permanent establishment. If either is done, it would be sensible

to include a short time threshold, for similar reasons as in relation to employment income.

Tax treaties based on the OECD Model will eliminate the tax in such a case but the UN

Model would allow it, subject to a time threshold.65 The addition of a monetary threshold in

addition to or in lieu of a time threshold raises similar considerations as for employment

income. The UN (but not the OECD) Model includes such a threshold for independent

personal (i.e., professional) services but not for other services. Consistency across

employment, professional, and other high-cost services makes sense from a policy viewpoint,

but tax treaties will generally not produce this outcome.

Under domestic law, it is usually necessary (e.g., in relation to withholding on wage

income) to draw distinctions between employment and business income.66 Employers and

employees may gain some advantage (in relation not simply to the income tax, but also to

payroll-based taxes and even labor law) in converting what is essentially an employment

relationship into a business one. One way to achieve this is for the employee to form a

company that then contracts the services of the former employee to the former employer (the

person is now an employee of the company the person owns but has control over how much

income is received from the company as wages and how much in other forms). Domestic tax

laws often deal with this problem by expansively defining employment to include such cases

or by extending withholding to certain types of business income. As far as the former route is

adopted, the rules will generally flow over into tax treaties (tax treaties have a special rule for

directors of companies, sourcing directors’ fees by the residence of the company, although

under the domestic laws of most countries these fees are treated as employment income).

Arrangements designed to convert employment into business income have given rise

to particular problems in international situations through manipulation of the time limits for

taxing employment income under tax treaties. The OECD has accordingly developed rules

for treaty purposes that seek to determine whether there is a genuine employment. These

rules can be considered for use in domestic law. The rules address where the responsibility,

risk, and authority to give instructions lies, where the work is carried out, the method of

calculation of remuneration, who provides facilities, and the methods for the conduct of the

work.

One form of high-value service that is usually the subject of special rules concerns

entertainers and athletes. Their income can be structured, as they desire, as business or

employment income (in the latter case through the use of “star” companies similar to the

situation just dealt with). Whether the income is employment or business, it is sourced under

treaties by reference to the place of performance of the services without time thresholds.68

Monetary limits may be used to segregate highly paid pop stars from the lower-paid members

of, say, a visiting symphony orchestra, although tax treaties usually employ other methods to

make this kind of separation (usually based on exceptions for official cultural exchange

programs). Tax treaties also usually contain special provisions to look through star

companies to the entertainer or athlete and to attribute all the income to that person. A similar

rule may be useful in domestic law.

Even with some or all of this panoply of rules to cater to the problems of taxing highcost

services, the growing importance of services in the world economy is going to increase

pressure on both source and residence country taxation. A successful computer software

company, for example, could locate its programming and management staff in some suitably

pleasant tax haven and market its products through mail order solicited by advertisements in

computer magazines or on the Internet. Taxing the profits of such a company and the salaries

of its employees in the countries where its products are sold is almost impossible, is not

provided for in the domestic laws of most countries, and may be prevented by tax treaties.

Similarly, much of the income of entertainers and athletes comes from sources not directly

related to actual performance, such as video and sound recordings and endorsements.

Capturing this indirect income by the country of place of performance entails the same kinds

of problems.

As already noted in the discussion of business income and royalties, some countries

are responding to this problem by employing a definition of source based on the residence of

the payer.70 As yet, such a shift does not have general international acceptance. This may,

however, be a case where it is wise for domestic law in developing and transition countries to

depart from the norms implicit in existing tax treaties and to seek to change their treaty

practice accordingly. Considerable resistance will be encountered in tax treaty negotiations

with industrial countries if a developing or transition country adopts this course.

***4. Pension Income***

A form of income often closely related to services income is pension income. Where

the pension has been financed by contributions out of services income that have received

favorable tax treatment in the country of performance (by exclusion of the contribution from

income or a deduction for the contribution), a rule based on the place of performance of the

services may be thought suitable for sourcing the pension. This approach will not be practical

when the services have been rendered in many countries over a period of many years. For

this reason and because pensions can take other forms (such as government benefits,

distributions from social security schemes, and purchased annuities), they are often sourced

by the residence of the recipient of the pension or by the residence of the payer of the

pension. The OECD Model adopts the former while many tax treaties in practice adopt some

form of the latter, especially in regard to social security and government benefits. The UN

Model adds, in one of its variants, a permanent-establishment sourcing rule as a gloss on the

residence-of-the- payer rule. Pensions and similar payments also give rise to some more

general problems under international taxation, which are taken up below.

In developing countries, pensions of all kinds are much less common than in

industrial countries, whereas they are widespread in transition countries. In both developing

and transition countries, pensions tend to be small in amount (especially as a result of recent

inflation in transition countries) and are often not taxable either because of an express

exemption in the domestic tax law or because they fall entirely within the tax-free zone

established by the tax rate scale or by personal allowances. Some developing and transition

countries have already experienced immigration of pensioners from industrial countries in

part to take advantage of a lower cost of living. It is not advisable therefore to be dogmatic on

a source rule for pensions.

As with residence rules, there may be special sourcing-type rules for government

employees. Although these rules are not often found in domestic tax laws, tax treaties

generally limit taxation of the employee’s wages to the government employing the person,

except for local employees. A variant of this rule is extended by tax treaties to pensions paid

by the government to its former employees.

**H. Other Income**

For other income,71 the OECD Model basically adopts a residence-only tax rule. The

UN Model allows the country of source to tax the income in accordance with its own source

rules without defining such rules. The domestic law of a transition or developing country can

sensibly adopt this approach with some generally expressed source rule as a residual.