**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,

88In a number of industrial countries, for example, USA IRC § 877, the change of residence rules take the

form of subjecting the person to tax on gains on the disposal of assets for a period of time after the person

ceases to be a resident. If the developing or transition country exempts foreign income of expatriates (other

than employment income) from tax for a certain period, the problem of conflicting tax jurisdiction is likely

to be avoided.

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.

**B. Business Income**

In the case of business income of a nonresident sourced in a country, income

attributable to a permanent establishment (or otherwise associated with a permanent

establishment and sourced in the country) is generally taxed on a net assessment basis.

Tax treaties usually require this approach in the case of income subject to the business

profits article but, because of their convoluted drafting, the actual extent of this obligation

is not obvious at first sight. The business profits article is usually expressed to be subject

to other articles of the treaty, but then other articles either refer the matter back to the

business profits article in respect of profits attributable to a permanent establishment

(dividends, interest, royalties, and other income) or adopt in effect the same rule as the

business profits article (capital gains and implicitly, at least according to the OECD

Commentary,90 income from independent personal services).

Articles that may involve business profits and that override the tax treaty

requirement of taxation on a net basis concern income from immovable property (above),

international transport, and entertainment and sporting activities. In the case of

international transport, source taxation is generally excluded (although the UN Model has

a little-used variant for shipping) and in the case of entertainment and sporting activities,

taxation on a gross withholding basis is permitted. Taxation by withholding is usually

permitted for dividends, interest, and royalties that are not attributable to a permanent

establishment.

To the extent that the domestic law provides for taxation, on a net or a

withholding basis, of technical fees paid to nonresidents, tax treaties will usually override

and prevent the tax levy if the fees are not attributable to a permanent establishment

while requiring as a result of the nondiscrimination article that a deduction be given to

the permanent establishment or resident company that incurred the expenses, subject to

the amount being arm’s length in the case of related parties. Nonresident companies may

try to exploit this situation, but depending on the circumstances, it may be possible to

find means within the tax treaty to levy tax on both the technical fees and on the salaries

of the personnel providing the services.91 It was noted above that most tax treaties do not

deal separately with insurance and telecommunication income, so that the permanent

establishment requirement applies, with the result that the profits from these activities in

a country are often not taxable. A number of countries nonetheless apply (relatively low,

say, 5 percent) flat-rate withholding taxes on insurance premiums, either in the

international area specifically or more generally and seek to protect this levy in their tax

treaties.

One particular problem that some transition countries experience in the area of

business income is the treatment of deductions. In a number of countries, the tax laws, for

the purpose of wage control, have denied deductions for wages in excess of a very low

threshold. Deductions for other expenses, such as advertising and interest, may also be

limited. There has been some debate on the extent to which the requirements of tax

treaties that permanent establishments be taxed on a net basis override provisions of

domestic law that deny deductions that affect the determination of profit. While it is

unlikely that tax treaties will be interpreted to override the denial of deductions in

marginal areas where denial is quite common under domestic laws (e.g., entertainment

deductions), it is another matter where a fundamental matter of profit determination such

as the treatment of wages is concerned.

A number of industrial countries have inserted special provisions in their recent

tax treaties with transition countries to attempt to clarify the matter for permanent

establishments and to ensure that subsidiaries of direct investors from their countries also

get deductions for their full wage costs (because the only tax treaty rule that potentially

covers the subsidiary case, the nondiscrimination article, is unlikely to be of assistance).92

Some transition countries have modified domestic law so that the denial of wage

deductions does not apply to branches and subsidiaries of foreign direct investors, and

others have repealed the wage deduction denial entirely. For some industrial countries,

these rules in the transition country tax systems have raised the more fundamental

question of whether their “profit” taxes are income taxes at all in the generally

understood sense and have consequently slowed down the development of tax treaty

networks.

**C. Dividends, Interest, and Royalties**

In the case of dividends, interest, and royalties paid to nonresidents, domestic law

usually provides for flat-rate final withholding tax on the gross amount if they are

sourced in the country and not attributable to a permanent establishment. The tax rate is

IV(G)(3), or to find that there is a permanent establishment of the parent company on the basis of the use of

the subsidiary’s facilities, which will mean that the business profits article of tax treaties will apply to the

technical fees received by the parent company and the employment article to the employees so that both are

taxed in the source country. Alternatively, tax treaties may provide for the taxation of technical fees

through extension of the royalties article or addition of a special article on the topic; *see supra* note 51 and

text.

92United Kingdom-Russia (1994 Exchange of Notes); the features of Russian law causing concern have

since been modified but similar problems remain with other transition countries.

typically set at 20–30 percent in developing and transition countries and then is often

reduced to 10–20 percent in tax treaties. The rates are set at this level in domestic law to

leave negotiating room in the tax treaty process but usually to be below the normal

company tax rate in recognition of the fact that the tax is gross and does not take account

of expenses. In tax treaty negotiations, developing and transition countries will come

under considerable pressure from industrial countries to reduce withholding tax rates on

interest and royalties to zero or near zero (special considerations applicable to dividends

are discussed further below). The argument used by industrial countries is that the gross

tax often wipes out the entire profit, with the result that the price charged to the resident

or permanent establishment in the country is increased (i.e., the tax is passed back to the

payer) with adverse consequences for the import of capital and technology.

While gross-up for withholding taxes (usually by increase in the interest or

royalty rate) undoubtedly occurs and is detrimental to developing and transition

countries, reduction of tax rates to zero or near zero likewise produces problems and the

appropriate course to take is a matter of judgment. If the treaty tax rate on interest is 10

percent, then banks that lend to residents of the country will find it difficult to make a

profit. For example, if the cost of funds of the bank is 9 percent and its lending rate is 10

percent, then on a loan of $1,000 it will make $10 before tax and other expenses besides

interest, but the withholding tax will be $10 and so wipe out the profit, forcing the bank

to increase the interest rate (assuming that it cannot use the excess foreign tax as a credit

against other domestic tax in its residence country). If the OECD Commentary’s

suggestion to deal with this problem is followed and loans from banks are exempted from

tax,93 this opens the way for simple back-to-back transactions, which will mean that the

exemption will be effectively extended to nonbank lenders. If a nonbank nonresident

lender deposits money in a nonresident bank and the bank then makes a corresponding

loan to a resident (less a small fee), what is effectively a loan from a nonbank becomes

for treaty purposes a loan from a bank and is protected accordingly. Some of the

problems of this kind can be dealt with better by provisions in domestic law that remove

the withholding tax on interest for borrowings in the international capital markets where

the debt is widely held (often referred to as Eurocurrency loans). The widely held

requirement substantially removes the problem of back-to-back transactions. Many

industrial countries have such provisions in their laws.94 Nonetheless, in a few cases,

reduction of interest withholding to zero under treaties is common for developing and

transition countries, especially for concessional loans made by development banks. A

general lowering of the interest withholding rate to zero also worsens the thin

capitalization problem described below.

Similar considerations apply to royalties, which are also particularly associated

with the problem of treaty shopping discussed below. Hence, there is a good argument for

developing and transition countries to have a reasonable positive tax rate on interest and

royalties under tax treaties (say, 10–15 percent). If royalties include equipment leasing

rentals, there is also a strong argument for uniform tax rates under tax treaties on interest

and royalties; indeed, the possibilities for conversion from interest to royalties or vice

versa, especially in the case of related parties, extend beyond this area so that equivalence

should be a goal in any event. Perhaps more important, because of the problem of treaty

shopping, it is imperative to have the rates similar or the same across tax treaties with

other countries in the case of interest and royalties. The industrial countries generally (but

reluctantly) accept this position in their tax treaties with developing and transition

countries; however, they often negotiate most-favored-nation clauses in protocols to the

tax treaties in such cases, so that if the developing or transition country grants a more

favorable rate or treatment to another developed country (often defined in terms of

membership of the OECD), then either the more favorable treatment is automatically

extended to that country or an obligation to renegotiate that tax treaty arises.95

**D. Capital Gains**

Capital gains of nonresidents present a more difficult problem for withholding.

While it is possible to have flat-rate withholding based on the sale price either generally

or specifically in the case of nonresidents, the gain part of the sale price can vary

considerably, and so an option for net taxation should be provided for in domestic law

with appropriate administrative safeguards.96 Enforcement of such withholding is likely

to be feasible only in the case of land (because land transactions are usually registered in

some way and the collection of tax can be tied in with this procedure) or of a permanent

establishment (with the gain taxed on a net basis like most other business profits). Many

countries do without withholding in such cases, as it is possible with appropriate

administrative mechanisms to deal with the capital gains.97 Attempts to levy capital gains

in other cases will generally be overridden by tax treaties and any attempt to protect the

power to levy tax on gains on shares in resident companies is likely to be futile for

reasons already explained.

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

Employment income of nonresidents is usually subject to the normal wage

withholding and not to any special final withholding, despite the policy arguments that

flat-rate withholding is the appropriate method for nonresidents. There are special

collection problems where the employer is a nonresident, but tax treaties usually will

95For example, most of Australia’s tax treaties with European countries have such protocols.

96As long as inflation is significant and property rights have not been clarified in transition countries, the

introduction of a capital gains tax is probably not a high priority generally, let alone in the case of

nonresidents.

97For example, Australia has general power in AUS ITAA § 255 to require a person owing money to a

nonresident to pay tax owing by the nonresident on receipt of a notice from the tax administration; this

procedure can be utilized in the case of substantial capital gains that come to the notice of the tax

administration (which may put a watch on land registers for that purpose).

protect the employee from taxation by the country where the work is performed in this

event through the 183-day rule unless a permanent establishment bears the wages (in

which event enforcement will not usually be difficult). If the employee is present for 183

days or more, residence will usually arise and the more permanent connection with the

country will facilitate withholding, although it is easy for temporarily present employees

to slip through the net unless attention is given to this issue by the tax administration.

Powers in the domestic law for the tax administration to prevent a person from leaving a

country unless taxes are paid can provide some assistance to tax collection depending on

how easy or difficult it is to exit the country.

Some transition countries find it difficult to cope with withholding on wages of

expatriates because their wages are paid into bank accounts in foreign countries. This is

partly a function of some wage taxation laws applying only to wages paid in a country

(which should be rectified if necessary, making clear that the law applies to wages

sourced in the country, whatever the place of payment) and partly a surrender to the

difficulties that the international border creates. Most employers, however, will not use

such a device to avoid tax as the penalties on employers for failing to withhold are

typically and appropriately severe. Moreover, this is one area where information

exchange under tax treaties with the country of the employer can be effective in assisting

the tax administration.

Although wage withholding often is not formally final, the way in which

obligations to file tax returns are expressed in many developing and transition countries

means that many employees are taxed through withholding only, so that in effect the

withholding is final.98 In the case of nonresident taxpayers, returns are not usually

required or forthcoming so that the withholding is final in fact. For expatriate taxpayers,

adoption of any of the special rules set out above may mean that special attention has to

be given by the tax administration to withholding on wages and filing of returns in their

case to prevent abuse of the rules.

Some countries extend withholding beyond the employment area (including

deemed employments discussed above) to certain services rendered in a business context.

As already noted, such income is required by tax treaties generally to be taxed on a net

basis, but this obligation can be satisfied by permitting such taxpayers to file returns and

to have the withholding credited against the tax liability (with refunds where necessary).

The language of tax treaties (although not perhaps the OECD Commentary)99 suggests

that final withholding on professional income is permitted where there is a fixed base (or

a presence time limit is exceeded if included in the treaty).

98*See generally supra* ch. 15.

99Commentary art. 14, para. 3 states that taxation under art. 14 should be levied on a similar basis to the net

taxation of business profits under art. 7, although there is nothing in the wording of the article to suggest

the limitation; the OECD is currently considering whether art. 14 should be dropped from the Model, which

would have the result of net taxation under art. 7 applying in such cases.

For entertainment and sports-related income, flat-rate final withholding is clearly

permitted under tax treaties and provides a simple and effective method of collecting tax

via the promoter of the event. Provision for some form of withholding on this income at a

reasonably substantial rate, such as 30 percent, should be provided in the domestic law

and should apply whether the income accrues to the entertainer or athlete directly, which

is very rare, or to some intermediary; that is, the law should permit the tax authorities to

look through the intermediaries to the entertainer or athlete.

In the case of pensions, withholding in accordance with the rate scale for

individuals is often provided for in domestic law in a similar way as for wage income.

Tax treaties may override any tax depending on the source rule adopted (see above).

Likewise, wage and pension income of the employees or former employees of foreign

governments will usually be subject to withholding under domestic law in the same way

as other wages and pensions, but tax treaties may remove the levy of this tax.

**F. Company and Shareholder Taxation**

The relationship of taxation of company and dividend income in the international

setting raises a number of special issues. One major distinction is between direct and

portfolio investment. Direct investment refers to the case where the investor in a

company has a large enough interest to influence the operations of the company, while

portfolio investment is the opposite case of no influence. This distinction often runs

throughout the laws and commercial practice of a country (in such areas as takeovers,

investment, banking, and accounting, as well as taxation) and may be defined differently

for different purposes, although often the taxation definition is affected by treatment in

other areas of the law. It is usually defined in terms of owning a certain percentage of the

capital or controlling a certain percentage of the votes in a company, with 10 percent and

25 percent or more for direct investment being the most common in taxation laws. The

OECD Model uses 25 percent of the capital, while a number of industrial countries use

10 percent of voting power in their tax treaties.100 The discussion that follows will

commence with portfolio investment and then move on to direct investment.

***1. Integration Systems***

The simplest tax system for companies and shareholders is the separate system;

that is, the company is taxed on its income and then dividends paid by the company are

taxed as part of the income of the shareholder without reference to any tax paid by the

company. Whatever the method of tax collection under this system in a domestic case

(where a resident company pays a dividend to a resident investor), frequently a flat-rate

withholding tax is levied on dividends paid by resident companies to nonresidents. Tax

treaties will often reduce the rate contained in domestic law, the OECD Model and most

tax treaties specifying 15 percent for portfolio dividends.

100For example, Australia, the United Kingdom and the United States.

In recent years, many countries have moved away from the separate system

because of its well-known potential for distorting economic decisions by companies and

shareholders in the domestic context. Such “integration” systems may consist of some

form of imputation, a split corporate tax rate, or a zero or low tax rate on dividends (in all

cases with or without some form of equalization tax on dividends to ensure that corporate

tax has been paid on distributions of company profits). Domestic tax laws usually confine

the full integration benefits to resident shareholders and often continue to tax nonresident

shareholders under a separate system with flat-rate withholding taxes.101

Most recently, with the growth of international investment, attention has become

focused on the potential for international economic distortions from integration systems

of these kinds. This issue has led some countries to extend some of the benefits of

integration to nonresident shareholders unilaterally or by tax treaty, for example, by

partly removing withholding taxes on nonresidents102 or by giving imputation credits

partly to nonresidents.103 Some countries have sought to go further and completely

equalize the treatment of residents and nonresidents. A simple approach is to align or

approximate the corporate and maximum individual tax rates and to exempt dividends

from further taxation whether paid to resident or nonresident shareholders.104 From the

point of view of the source country (where the company paying the dividend is resident),

neutrality may be achieved with such a system. For nonresident portfolio investors,

however, neutrality is unlikely because their residence country will almost invariably tax

them on the dividends without any benefit of whatever integration system that country

has for its resident companies (if any) and with a foreign tax credit only for any

withholding tax levied on the dividend by the source country (as distinct from the

corporate tax levied on the company paying the dividend).105

Hence, there is still a bias in the international tax system for resident shareholders

to invest in resident companies that other countries cannot prevent under this or any other

form of integration. This bias is now providing policy support for the separate system of

company and shareholder taxation, as such a system does treat residents and nonresidents

more or less alike if the country of residence of the company taxes shareholders resident

101For comprehensive treatment of the imputation system in the international setting, see Peter Harris,

Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries (1996). *See also*

*infra* ch. 19.

102AUS ITAA § 128B(3)(ga); countries with U.K.-style imputation systems simply do not levy withholding

taxes on dividends, whether paid to residents or nonresidents, though they may levy equalization taxes on

which see below.

103For example, France and United Kingdom.

104Ward Hussey & Donald Lubick, Basic World Tax Code and Commentary § 164 (1996).

105Some countries seek to overcome the tax credit problem in the residence country of the investor by in

effect converting part of the corporate tax into a creditable withholding tax, for example, New Zealand

under its domestic law and the United Kingdom in its typical treaties extending imputation benefits to

nonresidents.

there on dividends received and if other countries tax shareholders resident there on the

dividends, with a credit for any source country withholding tax.106 In fact, the position is

more complex, as a large proportion of international portfolio investment is made by

institutions that are taxed under special regimes in their residence country.

From the point of view of developing and transition countries, a fairly standard

treatment of nonresident portfolio shareholders with a flat-rate withholding tax and a tax

treaty rate limit of 15 percent is the simplest solution. Any attempt to extend integration

benefits to nonresidents generally is likely to produce a transfer of tax revenue to capitalexporting

industrial countries without providing any incentive to invest to the nonresident

(or rather without removing the disincentive to invest abroad that arises from the

residence country tax system).107 Even if it is decided to extend integration benefits to

nonresident portfolio shareholders, it is better to do this unilaterally rather than in tax

treaties (even if the domestic law confines the benefit to countries with which there is a

tax treaty), because such treaty provisions can lock the country into the form of

integration it has adopted. As integration (in the past at least) has been primarily a

domestic tax policy issue, integration benefits in tax treaties can become the international

tail that wags the domestic dog.

A removal of dividend withholding tax on foreign tax-exempt pension funds as

part of a regime of reciprocal recognition of the special tax arrangements that many

countries use to encourage private pension schemes may be considered. This is usually

done outside tax treaties (though note the comments above in relation to tax treaty

provisions dealing with contributions to pensions schemes by expatriates) and across all

types of investment income, rather than just for dividends.108

A country employing an equalization tax as part of its integration arrangements109

must take care in drafting it to ensure that it does not conflict with tax treaties. Often,

such a tax will be effectively at the corporate tax rate and will be triggered by the

payment of dividends. It can therefore be viewed as a withholding-type tax on the

dividends, in which event there is potential for the tax rate limits in tax treaties to reduce

the amount of the tax and so defeat or at least blunt its purpose. There are well-accepted

106OECD, Taxing Profits in a Global Economy 195 (1991); the United Kingdom in its 1997 budget

effectively abolished its imputation system in the international setting; *see* Edge, *The Last Piece of the*

*Jigsaw,* The Tax Journal 2 (Aug. 4, 1997); Harris, *supra* note 100.

107The United Kingdom sought to remove this disincentive from its imputation system with the foreign

income dividend scheme introduced in the early 1990s, but this scheme was withdrawn and the whole issue

opened up for review in its 1997 budget; *see* notes 101, 105.

108AUS ITAA §128B(3)(a), referring to § 23(jb).

109This tax is designed to ensure that tax credits given under an imputation system to shareholders are in

fact supported by tax paid at the corporate level; this can be achieved by levying tax on the company every

time it makes a distribution, as in the United Kingdom or under an accounting mechanism that matches

dividends paid with corporate tax and applies the equalization tax only when there is no matching corporate

tax, for example, Australia, France, New Zealand, and Singapore.

drafting devices to ensure that such a tax is not regarded as a withholding tax on

dividends.110 First, no primary or secondary tax liability can be imposed on the

shareholder in relation to the equalization tax, so that it is clearly a tax on the company

rather than on the shareholder. Second, it helps to use the dividends simply as a measure

for the amount of the tax and not to express the tax as being levied on the dividends as

such. Technically, the tax also needs to be at the corporate rate on the amount of the

dividend plus the tax, which is most easily done by expressing the tax rate as

*t*/(1 - *t*),

where *t* is the corporate tax rate.

The drafting arrangements for the U.K. advance corporation tax provide a model

that can be used to ensure that there is no conflict between the equalization tax and tax

treaties (although the basic rate of tax and not the corporate rate is used in the United

Kingdom).111U.K. imputation system, but these features initially remained intact, *see*

*supra* note 105. A subsequent Inland Revenue consultative document of Nov. 25, 1997,

proposed abolition of the advance corporation tax, which has been a critical part of the

system, and gave rise to the issues considered in the text.

***2. Reduction of Dividend Withholding Tax on Direct Investment***

In the case of dividends generated by direct investment, the international tax

position is very different from portfolio investment from a number of perspectives. A

foreign direct investor (assumed in what follows to be a company) generally has a choice

as to the legal structure of its investment in a country. It can establish a branch

(permanent establishment) or a subsidiary (i.e., a separate company).112 The residence

country of the direct investor will grant relief for double taxation by way of a credit or an

exemption for corporate tax levied on a branch by the source country (where the branch

is situated). It will generally extend this relief to corporate tax levied on a subsidiary

when dividends are paid to the direct investor so as not to produce a tax bias in the form

of investment.

In its turn, the source country will, by various means, approximate the tax

treatment of branch and subsidiary for the same reason. The major likely difference in

source country tax treatment in the absence of special provisions in the domestic law or

treaties will be that dividends paid by a resident subsidiary to a nonresident parent

company are subject to flat-rate dividend withholding tax, while remittances by a branch

110However, sometimes the tax is purposely structured in the opposite manner, in order to make it a

creditable dividend withholding tax in the hands of the shareholders.

111GBR ICTA § 14, pt. VI, chaps. IV, V, VA. The 1997 U.K. Budget radically altered the

112The term “subsidiary” will be used in what follows although it is often used only to refer to the case of

control of, rather than influence over, a company; as noted above, direct investment is usually defined in

terms of influence rather than control.

to its head office (the functional equivalent of dividends) are not subject to any tax. The

source country can address this disparity by reducing the tax on direct investment

dividends, or by taxing branch remittances, or by a combination of both.

Although it is possible for domestic law to provide a lower tax rate on direct as

opposed to portfolio dividends paid to nonresident shareholders, until recently this

reduction was most commonly only effected by tax treaties (with 5 percent being the

OECD Model norm). Developing and transition countries need not be too concerned with

accepting such arrangements for direct investment in treaties, especially where an

equalization tax is in place, but it is noticeable that a number of such countries (along

with some smaller industrial countries) do not draw the portfolio/direct investment

distinction in the dividend article of their tax treaties and apply the same rate of tax to

both. Unlike the case of portfolio investment, a lower rate of tax on dividends on direct

investment does not usually operate as a transfer of revenues to industrial countries

because of the different tax regime in most of them for dividends on direct investment

(exemption or underlying foreign tax credit). A small but positive tax treaty rate in the

source country also provides some incentive for reinvestment of profits (a major source

of investment) by foreign investors without unduly distorting the tax position in the

residence country of the investor.

There is now a more general international trend for reducing withholding taxes on

dividends paid to nonresident direct investors outside tax treaties. One effect of the tax

reform that took place in many countries in the late 1980s was to more closely align the

tax base and tax rate applied to companies in industrial countries. This meant, for direct

investments through subsidiaries, that the corporate tax in the country of the subsidiary

would approximate the corporate tax that the same amount of profit would attract in the

country of the investor. As that country would relieve double taxation for the corporate

tax paid by the subsidiary, the net effect was to wipe out any corporate tax in the

residence country of the investor whether a credit or an exemption system was used, but

the dividend withholding tax would remain as an additional tax levy above the residence

country tax.

A number of major econometric studies in the early 1990s suggested that such

withholding taxes were the main factor accounting for a bias against cross-border

investment, and hence some pressure has developed for their removal, even though tax

treaties typically contain lower tax rates on dividends from direct investment.113 The fact

that the United States typically demands for its resident investors a share of the action in

integration systems adopted by foreign countries has also been an influence here.

Developing and transition countries that do not have tax treaty networks may therefore

wish to consider setting the cross-border dividend withholding tax rate on direct

investment at a lower rate (say, 10 percent) than the traditional and typical 20–30 percent

tax rate that has been adopted across the board by many countries for dividends, interest,

113OECD, Taxing Profits in a Global Economy (1991), CEC, Report of the Committee of Independent

Experts on Company Taxation (1992). The initial enthusiasm for this analysis, which gave rise to a number

of initiatives in the EU seems to have cooled.

and royalties. There is, however, little reason to adopt a selective zero tax rate on

dividends in domestic law as part of regimes of tax incentives for foreign direct

investors.114 As the benefit is only likely to operate long after the initial investment

occurs, it has little impact on initial investment decisions and does not encourage

reinvestment of profits.

A similar pressure to reduce cross-border dividend taxes may arise when

countries form a free trade bloc, given that one of their longer-term objectives is usually

to remove not just trade barriers but also investment and other barriers to the creation of a

common market. This means that taxes applying only at the border (such as a nonresident

dividend withholding tax) become targets of the institutions of the common market. Thus,

the EU after many years’ debate has adopted a directive that will remove cross-border

dividend withholding taxes in the case of direct investment.115

This trade bloc reasoning also applies to other income flows within corporate

groups, and the EU has a draft directive extending the same treatment to interest and

royalties in direct investment cases.116 However, the reasoning here is very different

from the more general argument in relation to dividends and does not make sense outside

a trade bloc. The reasoning is that interest and royalties will be taxed in full in the

residence country, which is a member of the bloc, and, as long as investment flows are

balanced among the countries in the bloc, the revenues of members do not suffer

(alternatively, government-to-government reimbursement mechanisms can be devised if

flows are not equal), while at the same time the border impediment is removed.

For developing and transition countries, investment flows are not usually in

balance with other countries (even in the Commonwealth of Independent States (CIS),

the loose trading bloc formed by most of the countries of the former Soviet Union), and

interest and royalties are payments that reduce the tax base (as they are usually deductible

in the calculation of taxable profit), with significant potential for causing problems for the

taxation of direct investment. Hence, the advice given in relation to these payments above

was to maintain reasonable levels of tax at relatively uniform rates in both domestic tax

law and treaties. The existence of a trade bloc does not change that advice.117 More

generally, developing and transition countries need to be very cautious in studying the tax

arrangements in trading blocs of industrial countries, especially the EU, even where they

114*See infra* ch. 23 for a discussion of such incentives.

115Council Directive 90/435/EEC art. 5.

116COM (90) 571, OJ C53, 26 (1991).

117From the point of view of the residence country, it is imperative to tax interest and royalty income where

source taxation has been reduced or eliminated by tax treaty or trade bloc arrangements and tax treaties and

trade blocs assume such a regime; the arguments that can be made for operating an exemption system in

relation to dividends on direct investment do not apply to interest and royalties because the underlying

assumption is that dividends are not deductible in the source country in determining the taxable profit of

the subsidiary.

have ambitions to become members of the bloc. Where a group of developing or

transition countries form a trading bloc, care should be used in extending special free

trade arrangements to taxes, as the countries may not have the capacity to deal with the

more sophisticated rules often involved. For example, the international value-added tax

and excise rules within the CIS have been an on-going problem.118

***3. Branch Profits Tax***

In the case of direct investment in the form of a branch, the branch profits tax

represents a strategy to even up treatment of branches and subsidiaries. To produce

precisely the same outcome, it is necessary to define branch remittances that equate to

dividends and to tax them at the same rate that applies to dividends on direct investment.

While the statement of the principle is easy enough—the amount of remittance

can be determined by comparing the branch’s tax balance sheets at the beginning and end

of the tax year—in practice the elaboration of the principle has generally proved very

complex, even though to some extent it is based on the same information used to

determine the taxable profit of the branch. Some countries therefore use a simpler but

rougher measure, namely, the after-tax taxable profit of the branch. To take account of

the fact that subsidiaries typically do not repatriate all of their after-tax profit as

dividends, the rate is often set lower than the dividend withholding tax rate based on an

assessment of the typical payout ratio of subsidiaries of foreign investors in the country (a

tax rate of one-half the dividend rate or less being appropriate in most cases).

Certainly, some rules for calculating the amount subject to branch profits tax need

to be set out in domestic law. It is neither sensible nor transparent to introduce the tax by

the back door by defining all branches for tax purposes to be subsidiaries so that

remittances (presumably) become dividends and, thus, subject to dividend withholding

tax. The tax administrations of developing and transition countries will not be able to

detect remittances as they occur (the possibilities of method of remittance being infinite

and the only practicable measurement device being comparison of tax balance sheets at

the beginning and end of the tax year). Although there will in some cases of more exotic

legal entities be difficult cases of characterization as branch or subsidiary, this is not a

reason for the tax law to impose an arbitrary rule that is contrary to generally accepted

international norms of taxation in clear cases.

A number of developing and transition countries are considering or have enacted

branch profits taxes, in some cases, without apparent regard to their tax treaties. Treaties

based on the OECD and UN Models override the levy of a branch profits tax,119 and the

treaties in question do not generally contain the necessary modifications to the dividend

and nondiscrimination articles to accommodate such a tax. Although new treaties that are

118*See* Victoria Summers & Emil Sunley, *Analysis of Value Added Taxes in Russia and Other Countries of*

*the Former Soviet Union*, 10 Tax Notes Int’l 2049 (June 19, 1995).

119See arts. 10(5) and 23(3) of the OECD Model.

negotiated can contain these modifications, the existing treaties will encourage treaty

shopping to short-circuit the effect of the new treaties, and it will be many years before

replacement treaties can be put in place.

Further, it is not possible to either tax all effective remittances or achieve in

practice the close approximation of the tax treatment of branches and subsidiaries that the

branch profits tax is aimed at, because of the interaction of the tax treatment of dividends

and capital gains in the context of the branch or subsidiary. Both the dividend

withholding tax and a branch profits tax based on remittances can be avoided by not

paying dividends or remitting profits, as the case may be, that is, by reinvesting the

profits. The gain in each case can then be realized by selling the shares in the company

operating the branch or in the subsidiary (or in a holding company in the corporate

group). This gain will usually not be taxable in the source country because of either tax

treaties or the inability of domestic law to reach sales of holding companies based in

other countries (not to mention the lack of the capital gains tax in many developing and

transition countries).

Sale of shares in this way thus achieves an effective remittance of reinvested

profits of the branch or subsidiary, but in practice it will be more difficult for a branch to

achieve such a sale because the branch will usually be just one part of the operations of

the company, with the result that sale of the shares will amount to much more than a

realization of the reinvested profits of the branch. Further, as far as capital gains (in

excess of those arising from reinvestment of profits) have been made on the investment,

the tax treatment of branch and subsidiary will usually differ in practice for the same

reason that disposal of the shares in the company operating the branch will often not be a

practical possibility. Disposal of the branch will usually be effected by the sale of its

assets, which will be subject to the capital gains tax of the country where the branch is

situated (if any), while the profits on the sale of the shares in the subsidiary will not be

taxed.

Hence, the value of a branch profits tax is doubtful. The tax pales into

insignificance when compared with some of the other problems of protecting the tax base

of the source country against the base-erosion techniques that are explored below. The

main reason why it is sometimes thought to be important for developing and transition

countries to have a branch profits tax is to fully tax income from natural resources where

many foreign investors typically operate in branch form mainly because of the generous

treatment of the early year start-up losses under their home country (especially U.S.) tax

law.

***4. Branches and Subsidiaries in Transition Countries***

The transition countries face a special set of issues in the branch and subsidiary

area, which demonstrates once again the problems caused by the lack of clear rules and

by departures from international norms in these countries. Under the commercial laws of

nontransition countries, there is a generally clear understanding of what is meant by a

body corporate (company, corporation) and of when an entity recognized by the law has

separate legal personality or not.120 However, the commercial laws of several transition

countries are still in the developmental stage, and it is often not clear when a separate

legal person exists or, more important, whether in a particular situation there are two

legal persons (parent company and subsidiary) or one legal person with a number of

operations (head office and branch).121

When a foreign legal person commences operations in a transition country, it is

usually required to “register” to do business under the commercial laws of the country. In

some of the countries, registration is regarded as the creation of a legal person, because

this is how the creation of a legal person is effected in a purely domestic case or, perhaps

more accurately, registering to carry on a business in a purely domestic case of itself

creates a separate legal person (as the registration is to get approval to do business, and

the creation of a separate legal person is a by-product of registration). Representation

offices of foreign persons are usually recognized and are not treated as separate legal

persons (a separate registration procedure is required in this case), but the functions that

such offices can perform under the laws of the transition countries are generally strictly

limited as befits their name.

Before 1989, the question of registering foreign legal persons under domestic

procedures did not arise for many transition countries because the only way a foreign

legal person could operate a substantial business venture in the country was through the

creation of a joint venture with foreign participation, for which special statutes existed.

The joint venture in these cases was a separate legal person under the statues and the

foreign joint venturer a substantial shareholder along with the state-owned enterprise also

involved in the venture.

Moreover, in several transition countries (especially members of the CIS), the

profits tax is not levied on a legal person as such, but on the separate operational units of

the legal person (which may in turn be linked to separate registration of the operational

units with the local or regional authority of the area where they are located).122 Thus if a

state-owned enterprise has a glass factory in one city and a television factory in another

city, both the factories will often be taxed separately. This may affect rates of tax as in

many of the countries there are varying tax rates depending on the nature of the business

of an operational unit or the region where it is operating, and, more important, it may

affect the treatment of losses, as a loss incurred by one operational unit may not be offset

against the profit of another operational unit. This fact makes it less necessary under the

systems of some transition countries to distinguish in a particular case whether one legal

person is involved or two. Again, this system grew up in the closed days of central

planning so that international issues did not intrude. Hence, putting aside the case of the

representation office, questions did not arise as to whether a branch of a foreign legal

person was taxed in this way (assuming that a branch was possible under the system in

question) and as to whether operational units (including those of foreign legal persons)

were taxed on their worldwide profits.

These rules have a number of important implications for international taxation

and tax treaties in cases of direct investment by industrial country resident companies in

transition countries. In many of them, what the industrial country resident regards as a

branch (permanent establishment) will often be treated as a subsidiary by the transition

country because it is registered in that country. Indeed, in one unusual case, this result

was regarded as arising from registration for turnover tax purposes. The “subsidiary” will

be taxed as a resident legal person by the transition country, and distributions to the

industrial country resident will be treated as dividends and subject to any tax treaty

accordingly (although some of the transition countries have no taxes on dividends).

If the legal system of the transition country in question characterizes an operation

within its borders as a separate legal person, then the private international law rules

applied in most industrial countries will lead to the recognition of this characterization by

the general law and usually the tax law of the industrial country in question. However, in

many cases, the industrial country resident will not be aware of either the legal intricacies

involved or the very different legal structures in some transition countries.

In a number of transition countries, the concept of a branch has become fully

accepted for both commercial and tax law purposes, although even then exchange

controls may make operation in branch form impractical. In most countries, the extension

beyond the case of the representation office is piecemeal (e.g., banks and building sites)

and seems to require special procedures separate from the business registration

procedure. In some countries, the representation office is being put under a lot of pressure

as nonresident taxpayers try to establish branches for various reasons. Part of the pressure

results from the fact that the transition countries generally find it difficult to deal with

cases where the taxpayer breaches the law—in this case, when representation offices

engage in activities not legally permitted to them.

If the transition country in question taxes each operational unit separately, then

further tax issues arise for the industrial country resident direct investor, whether

branches are permitted generally or in special sectors or not at all. In the branch case, the

industrial country investor may find that losses on one branch operation will not be offset

against profits of another branch operation in the same country, which will be contrary to

the expected treatment. This has been a problem in some transition countries, particularly

in the oil and mining sector where each drilling rig or mine site is taxed separately.

There does not seem to be anything in article 7 of the OECD Model that precludes

this outcome (indeed, the Model seems to follow the approach of treating each permanent

establishment separately), and, as the same treatment is applied to domestic enterprises,

nondiscrimination is unlikely to be an issue. It is certainly the assumption of industrial

countries, however, that legal persons are taxed as a whole and not separately on

operational units, although in the source country only profits attributable to the permanent establishment are taxable, and not the worldwide profits of the legal person.123

A potentially more difficult question arises for the calculation of expenses. Treating each

branch separately in the calculation of tax may naturally lead to the disallowance of head

office expenses as deductions of the permanent establishment. The separate treatment of

the operational units for tax purposes in transition countries does not seem, however, to

produce the consequence that payments between them or to the head office receive

dividend treatment.

This range of issues has been the cause of considerable confusion among

industrial country investors, however (the precise legal situation varies from country to

country), and has had an additional chilling effect on foreign direct investment in a

number of transition countries and on the development of tax treaty networks with

industrial countries. One alternative has been for foreign investors to enter into special

tax contracts with the governments of transition countries that guarantee them a relatively

normal tax treatment by market economy standards. While these contracts solve the

problems of the particular direct investor, they are already complicating tax reform and

tax treaty development in a number of transition countries.

In general, it is recommended that transition and developing countries refrain

from entering into special tax contracts or at least limit the effect of the contracts to a

relatively short time before reviewing them. Further, transition countries should seek to

ensure that their commercial and tax laws accord with the general international

distinctions between branches and subsidiaries and that the tax position of an investor

with more than one branch in the country is aggregated across the branches. Several

transition countries have already taken these steps in recent years.

**G. International Tax Avoidance and Evasion**

While the source country may be concerned with ensuring that direct investors are

taxed in a way that does not bias the form of the investment and with collecting its fair

share of tax from both direct and portfolio investors, nonresident taxpayers may seek to

escape source taxation altogether or at least to minimize that tax. They may do so through

techniques to avoid or minimize tax , that is, arranging their affairs so that under the law

of the source country the tax is minimized, or through tax evasion, that is, deliberately not

complying with the law of the source country even though income is taxable under that

law.124 As with the issues of company and shareholder taxation discussed above, it is

helpful to draw a distinction between direct and portfolio investors; indeed, much of the

discussion under this heading stems from a number of the points already made. The

discussion below initially focuses on nonresident direct investors and then canvasses to

what extent the techniques outlined are available to nonresident portfolio investors and to

resident investors.

Within an international group of companies investing directly in various

countries, what generally matters to the managers and the ultimate shareholders is the

after-tax profit of the group; in other words, the corporate group usually has an economic

incentive to reduce its total tax payments and is economically indifferent as to the

countries to which it pays tax. In some cases, especially where the residence country of

the parent company in the group operates an imputation system that ties tax credits

available to shareholders to the company tax paid in that country by the parent and local

subsidiaries, the economic incentive may rather be to pay as much tax as possible in the

residence country. In any event, multinational companies investing in developing or

transition countries are likely to have an economic incentive to reduce the tax burden in

those countries, either as part of reducing tax burdens worldwide (i.e., reducing tax in

both residence and source countries) or as part of moving the tax burden to a country that

offers the greatest advantages to the ultimate shareholders of the company group.

This economic incentive may not always lead to tax avoidance or evasion.

Cultural, ethical, and nontax commercial factors may act as a counterbalance. With the

globalization of trade and investment, deregulation in many areas of international

business law, and international financial markets that focus on the “bottom line” and are

beyond the reach of any single government, the countervailing factors are likely to

weaken in influence over time. Most large multinational companies will nevertheless

want to conduct their tax planning within the law; that is, they are more likely to practice

tax avoidance or tax minimization than tax evasion. Tax evasion internationally and

domestically is more of a problem with small or closely held businesses and individual

taxpayers (see the discussion of capital flight above for the problem of evasion in relation

to resident taxpayers).

The simplest way to minimize tax is to make payments from the branch or

resident subsidiary to a related nonresident company that are deductible in determining

the amount of profit subject to corporate tax and that are not subject to withholding tax.

Alternatively, as a second best option, payments can be made that are deductible under

the corporate tax and are subject to a low rate of withholding tax.

In the past, two basic strategies (which can be combined) have been mainly used

to achieve these ends: increasing the prices of payments and changing the type of

payments. To take some simple examples, a local subsidiary operating an assembly plant

can pay inflated prices for the components and the technical and management services it

purchases from related companies; or a nonresident parent company can invest in the

subsidiary by way of loan capital rather than share capital and receive interest payments

(deductible to the subsidiary) instead of dividends (usually not deductible to the

subsidiary). Similar results can be produced by reducing the amount of payments for

goods or services to the local branch or subsidiary for goods or services it provides to

other (nonresident) members of the group. Recently, international tax planning has

become more sophisticated along with the financial markets.

The following discussion

will start with the simpler methods of tax avoidance and then move to more recent

techniques.