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**Revision of the Manual for the Negotiation of Bilateral Tax Treaties**

**Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties**

***Summary***

This note comprises the first part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on revision of the Manual. It provides an introduction to international double taxation. Other parts of the draft Manual are *presented* as addenda to this paper.

**PART ONE**

**INTRODUCTION TO  
INTERNATIONAL DOUBLE TAXATION AND  
TAX EVASION AND AVOIDANCE**

## I. INTERNATIONAL DOUBLE TAXATION

### A. Concepts and issues

1. International taxation issues revolve around two main concepts that are also fundamental reasons/causes of international juridical double taxation. These two concepts are known as the concept of source and the concept of residence. Both concepts arise from domestic tax law provisions, which distinguish between two types of taxpayers - non-residents and residents. The first category of taxpayers would generally have limited *nexus* (connection) with the country in question, however the income received by these taxpayers will have an economic link - will originate in the particular country. This country wishes to levy tax on this taxpayer, however only in respect of the income originated therein (having source in this country) - referred to as source taxation and sometimes known also as limited tax liability. The second category of taxpayers - residents - would have a close personal and economic connection (*nexus*) with the country in question and the country chooses to tax this taxpayer on his/her worldwide income - referred to as worldwide taxation and sometimes known also as unlimited tax liability. These two concepts are further explained in the sections below.

#### *Concept of Source*

1.1. The jurisdiction to impose income tax is based either on the relationship of the income (tax object) to the taxing state (commonly known as the source or *situs* principle) or the relationship of the taxpayer (tax subject) to the taxing state based on residence or nationality. Under the source principle, a State's claim to tax income is based on the State's relationship to that income. For example, a State would invoke the source principle to tax income derived from the extraction of mineral deposits located within its territorial boundaries. Source taxation is generally justified on the ground that the State has contributed to the creation of the economic opportunities that allow the taxpayer to derive income generated within the territorial borders of the State. Of course, jurisdiction to tax is also about power, and a State generally has the power to tax income if the assets and activities that generated it are located within its borders.

2. Income itself does not have a geographical location. It is a quantity, calculated by adding and subtracting various other quantities in accordance with certain accounting rules. By long standing convention, however, income is assigned a geographical location by reference to the location of the assets and activities that are used to generate the income. When all of those assets and activities are located in one State, that State may be considered to be the unambiguous source of the income. For example, wages paid to an employee stationed in a State that represent compensation exclusively for work performed in that State would have a source exclusively in that State. When some of the assets or activities generating income are located in more than one State, the source of the income is less clear. For example, business profits derived from the manufacture of goods in State A and their sale in State B have a significant relationship to State A and to State B. In these circumstances, some rules for determining source are needed. Those source rules might apportion the income between the two claimant States, or they may assign it to one State exclusively. In some cases, States may adopt inconsistent source rules that result in both States exercising source jurisdiction over the same item of income.

2.1. Income derived from sources in the country and received by taxpayers classified as non-residents would most often be defined as “income from sources in the country”. This definition would be quite an important part of international tax rules, since in absence of such definition, one could argue that the tax liability on non-resident may not arise. The list of items of income having source in the country can be both exhaustive or only indicative. Generally such definition would mention: “Income from sources in Contry Z includes the following items of income: (an exhaustive or indicative list would follow)”. The sourcing rules may also indicate that the income from sources would also include income, which was not physically paid from the country in question, but earned there in a way of provision of services, corresponding expense was claimed as a deduction in this country or otherwise connected to the taxing jurisdiction.

### *Concept of Residence*

3. Under the residence principle, a State’s claim to tax income is based on its relationship to

the person deriving that income. For example, a State would invoke the residence principle to tax wages earned by a resident of that State without reference to the place where the wages were earned. In general, a State invokes the residence principle to impose tax on the worldwide income of its residents. Basing the tax on the taxpayer's overall capacity to pay, without reference to the source of income, is consistent with most theories of distributive justice. Whatever the theory, a State cannot tax the worldwide income of its residents unless in practice it has the power to do so. A State typically has some degree of power to compel tax payments from its residents, but only if it has reliable information about the amount of income they have earned. Bilateral tax treaties containing appropriate exchange of information provisions or a multilateral agreement on exchange of information for tax purposes may assist a State in determining the foreign source income of its residents. A bilateral or multilateral treaty with an assistance-in-collection provision may also be helpful to a State in collecting taxes due with respect to foreign-source income.

4. The reach of a State's residence jurisdiction depends on how a taxpayer's residency is determined. Physical presence in a State for an extended period is an important indicator of residence. Some States also determine residency of an individual by reference to a variety of other indicators of allegiance to the State, such as the location of the individual's abode, his family, and his fiscal interests. In other States, physical presence in the State 183 days of the year is enough to establish residence for that year. Conflicts in residency rules can result in an individual being a dual resident - that is, a resident of two different States. The same issues arise in respect of legal entities. Legal entity can be considered a resident in the country of its incorporation, place of its head office or based on other criterion - such as place of effective management or control. Tax treaties generally do an excellent job at resolving problems of double taxation resulting from conflicting residence rules - using the tie-breaker rules in Article 4 paragraphs 2 and 3.

5. When income is derived within a State by a resident of that State, both the source principle and the residence principle can be invoked to support a tax on that income. A State can invoke only the source principle to tax income derived within its territorial boundaries by a non-resident. It can invoke only the residence principle to tax income derived by a resident from activities conducted outside the State's territorial boundaries. Most States utilize both the residence principle and the source principle. All States utilize the source principle.

6. A few States tax on the basis of the source principle alone (so-called territorial system).<sup>1</sup> The number of States using a territorial system has diminished, because countries have recognized that the failure to tax residents on income derived from foreign activities undermines the fairness of the tax system and provides residents with a tax incentive to invest abroad. Such an incentive is almost certainly contrary to the national interests of a State in need of capital for domestic investment. Nevertheless, if only a tiny percentage of the population of a State derives any foreign source income, the residence principle may have little practical importance to that State.

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<sup>1</sup> Taxing jurisdictions which historically use or have used the territorial system include: Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong SAR, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore and Uruguay.

7. States that invoke only the source principle are typically concerned about the ability of their tax department to determine the amount of foreign source income derived by their residents. In some cases, an exemption for foreign source income can complicate tax administration, due, for example, to legal disputes that may arise over the source of particular items of income or to the difficulties the tax administration may encounter in determining whether a deduction claimed by a taxpayer properly relates to domestic or foreign income. In some cases, a State exercising only source jurisdiction may be tempted to adopt source rules that may conflict with the source rules of other countries in order to tax income that does not present them with significant enforcement problems. They may be inclined, for example, to treat the income of government employees earned abroad as domestic source income.

8. A few States consider nationality as establishing a sufficient relationship between the taxpayer and the taxing State to justify taxation on worldwide income. Because it is based on the connection of the tax subject to the taxing State, this principle is best understood as a variation on the residence principle. The overwhelming majority of citizens of a State are also residents of that State. As a result, residence jurisdiction and nationality jurisdiction overlap considerably. The United States of America is the only State where tax jurisdiction based on nationality is important, although a few other States, including Bulgaria, Mexico and the Philippines, have used citizenship as a basis for taxation in the past. The United States of America generally does not tax its citizens on foreign earnings below a high threshold amount if they have established a foreign residence. Many countries take an individual's citizenship into account in determining whether that person is a resident. Tax treaties, including Article 4.2.c of the United Nations Model Double Taxation Convention between Developed and Developing Countries, use citizenship as a tie-breaker in resolving problems of dual residency.

9. The jurisdictional principle based on the tax object (source, *situs*) and tax subject (residence, nationality) were developed initially for individuals in the context of the personal income tax. States also invoke those principles, at least by analogy, in asserting the right to tax juridical persons or other entities, such as corporations and trusts. All States invoke the source principle in taxing corporations and other taxable legal entities. Many States also invoke an adapted version of the residence or nationality principle to tax certain corporations and other legal entities on their worldwide income.

10. Some States determine the residence or nationality of a corporation based on its place of incorporation.<sup>2</sup> Other States determine the residence of a corporation by reference to its place of management.<sup>3</sup> As a practical matter, most States using a place of management test employ some objective standard, such as the place where the board of directors meet, to determine place of management. Otherwise, the place of management would be indeterminate in many important situations. Some States use both a place-of-incorporation test and a place-of-management test.<sup>4</sup> A corporation that is subject to tax on its worldwide income may be able to avoid taxation on foreign-source income by creating an affiliated foreign corporation and arranging for that affiliated

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<sup>2</sup> e.g., United States of America, Sweden, France.

<sup>3</sup> e.g., United Kingdom (before 1988).

<sup>4</sup> e.g., United Kingdom (since 1988), Canada, Australia, Germany, The Netherlands.

corporation to earn the foreign-source income it otherwise would have earned. Most developed countries and some developing countries have adopted rules to tax their domestic companies on certain categories of income deflected to a foreign affiliated corporation for tax avoidance purposes.

### **B. The concept of international double taxation**

11. Double taxation can take different forms and occur in different situations. Sometimes double taxation is being distinguished based on the number of taxpayers involved. Cases where the same income is being taxed twice in the hands of the same taxpayer are being referred to as *juridical double taxation*. For example, the dividend is being taxed in the country of source by a way of withholding tax and then one more time in the country of residence of the shareholder by a way of tax assessment. Cases where the same income is being taxed twice in the hands of two different taxpayers are being referred to as *economic double taxation*. Continuing with previous example, the profit earned by the company, which paid the dividend may be subject to corporate income tax. Economically, the corporate profits and the dividends are the same income, however taxed in the hands of two different taxpayers - company paying the corporate income tax and the shareholder - subject to the taxation on the distributed profits. Double taxation may happen both in the domestic and cross-border situations. The tax treaties prevailing seek to eliminate the cross-border/international juridical double taxation. However in some instances, the tax treaties may also eliminate or reduce the international economic double taxation - e.g. by providing a reduced withholding tax rate on inter-company cross-border dividends (see Article 10, paragraph 2, letter a) or by providing the obligatory corresponding adjustment in case of transfer pricing situations (see Article 9).

12. Double tax conventions are an established way for States to agree at the international level on a method for reducing or eliminating the risk of double taxation. Double taxation may occur for any of the following reasons:

- (a) **Residence - Residence Conflict:** Two States may tax a person (individual or company) on his world-wide income or capital because they have inconsistent definitions for determining residence. For example, a corporation may be treated by State A as its resident because it is incorporated therein, whereas State B may treat that corporation as its resident because it is managed therein. As another example, State A may treat an individual as its resident for a taxable year under its domestic tax rules because that individual was present in the State for 183 days during that year. That same individual may be treated as a resident of State B under its domestic laws because the individual has lived in that State for many years and maintains close financial and social ties to that State. Residence-residence conflicts can occur rather frequently with respect to corporations, unless a corporation has intentionally made itself a dual resident to obtain the benefit of a loss in more than one State. This type of double taxation can be eliminated on the basis of tax treaties using the tie-breaker rules contained in Article 4 paragraphs 2-3 of the tax treaties, which determine the states, which would qualify as the only country of residence of the person in question.

- (b) **Source - Residence Conflict:** One State may tax income derived by a person by application of the residence or nationality principle, whereas another State may tax that same income by application of the source principle. For example, Company A, a resident of State A, may earn income in State B from extensive activities therein. State A would tax Company A on its worldwide income, which would include the income earned in State B. State B would tax the income arising from the activities conducted within its territorial boundaries. A major objective of bilateral tax treaties is to provide for relief from such source- residence double taxation, typically by requiring the residence State either to give up its claim to tax or to make its claim subordinate to the claim of the source State. This type of double taxation can be eliminated by the tax treaties, either on the basis of the exclusive taxing right - where the treaty permits only one country to tax the income, or on the basis of the methods for double taxation relief, where the country of residence will have the obligation to provide the relief (exemption or credit) in the way prescribed by the treaty to eliminate double taxation.
  - (c) **Source-Source Conflict:** Two States may invoke the source principle to tax the same item of income, due to conflicts in the way the source of income is determined under their domestic legislation. For example, the domestic tax laws of State A may provide that sales income of a non-resident corporation is taxable in that State if the sale was made through an office located in that State. In contrast, the tax laws of State B may tax income derived from sales by a non-resident corporation if the transfer of possession of the goods sold takes place within that State. Given this conflict in the tax rules of State A and State B, income derived from a sale made through an office located in State A for delivery in State B would be taxed in both States. Tax treaties may eliminate some of these situations, by providing sourcing rules, which will help to determine only one country of source.
  - (d) **Triangular Cases:** In some cases, a State may have a source-residence conflict with one State and a source-source conflict with another State. For example, assume that Company A is a corporation resident in State A. It has an office in State B and makes sales from that office into State C. Under their domestic laws, State A taxes income from those sales under the residence principle and State B and State C both tax that income under the source principle. A bilateral tax treaty between State A and State B is likely to solve the residence-source conflict but probably would not solve the source-source conflict. If State B and State C also have a bilateral tax treaty, however, the source-source conflict may also be solved.
13. A major goal of bilateral tax treaties is to remove impediments to international trade and investment by reducing the threat of double taxation that can occur when both Contracting States impose tax on the same income. This goal is advanced in four distinct ways. First, a bilateral tax treaty generally increases the extent to which exporters residing in one Contracting State can engage in trading activity in the other Contracting State without attracting tax liability in that latter State. Second, when a resident of a Contracting State does engage in a sufficient activity in the other Contracting State for that State to have the right to tax, the treaty establishes certain guidelines on how that income is to be taxed. For example, those guidelines may assign to one Contracting State or the other the primary right of taxation with respect to particular categories of income. They



may, in certain cases, provide for the allowance of deductions in measuring the amount of income subject to tax. They may require a reduction in the withholding taxes otherwise imposed by a Contracting State on payments made to a resident of the other Contracting State. Third, a bilateral tax treaty provides a dispute resolution mechanism that the Contracting States may invoke to relieve double taxation in particular circumstances not dealt with explicitly under the treaty. Fourth, where income or gains remain in principle taxable in both Contracting States, the State of residence of the taxpayer will relieve the double taxation that results either by allowing a credit for the tax paid in the other State or by exempting the income or gain from its own tax in practice.

14. Although a State may address the issue of double taxation unilaterally through domestic tax laws, it typically cannot achieve unilaterally many of the goals of a bilateral tax treaty. Domestic legislation is a unilateral act by a State. Such a unilateral act can reduce or eliminate double taxation only if the State is prepared to bear all of the financial cost of granting that relief. A bilateral tax treaty, by definition, is a joint act of two Contracting States, typically resulting from some negotiations. In that context, the financial costs of relieving double taxation can be shared in a manner acceptable to the parties. In particular, the domestic legislation of a State typically addresses tax issues without reference to the particular relationship that the State may have with another State. In a bilateral tax treaty, that relationship can be taken into account explicitly and appropriately. For example, a State may use a bilateral tax treaty to fashion a particular remedy for double taxation when the flows of trade and investment with the other Contracting State are in balance. It may adopt a different remedy, however, when the trade and investment flows favour one State or the other.

15. Bilateral tax treaties help to reduce the risk of double taxation by establishing the minimum level of economic activity that a resident of one Contracting State must engage in within the other State before the latter State may tax the resulting business profits. The bilateral tax treaty lays out ground rules providing that one State or the other, but not both, will have primary taxing jurisdiction over income derived from the branch operations in one Contracting State by a corporation that is resident in the other Contracting State. Similarly, the treaty may specify which Contracting State may tax income derived from the performance of services in one Contracting State by an individual who is a resident in the other Contracting State. In general terms, the tax treaty may assign primary (but not exclusive) jurisdiction to tax to the Contracting State in which the economic activities occur if those activities have substance and continuity that exceed some threshold level. When the economic penetration is relatively minor, however, exclusive jurisdiction to tax may be assigned to the Contracting State where the corporation or individual is a resident.

16. The scope of a bilateral tax treaty typically is not limited to commercial and business activities. Treaties may remove tax impediments to desirable scientific, educational, cultural, artistic and athletic interchanges. In addition, a treaty may address issues arising in the tax treatment of pension plans and Social Security benefits, of contributions to charitable organizations, of scholarships and stipends paid to visiting scholars, researchers, and students, and even of alimony and child support payments.

17. A bilateral tax treaty cannot anticipate every income tax issue that is likely to arise between Contracting States. Some issues, such as issues relating to the growth of electronic commerce, are difficult to address currently by tax treaty because the international community has not yet reached a consensus on the appropriate standard for taxation. The international community generally recognizes that the current treaty rules relating to the definition of a permanent establishment were

based on premises about how commerce is conducted that may not hold for electronic commerce. What is not yet well understood is the changes, if any, that the development of electronic commerce will require in the treaty definition of a permanent establishment. To deal with such emerging issues, the parties to a bilateral tax treaty may wish to agree to consult on those issues within a stipulated period after the treaty enters into force. The length of the period with respect to a particular issue might be chosen so as to allow time for an international standard on that issue to emerge, for example, from the Organization for Economic Cooperation and Development (OECD).

18. The typical tax treaty provides a mechanism enabling the tax authorities of the two States to adopt ad hoc rules to eliminate double taxation when it occurs. In tax treaty parlance, the tax authorities responsible for negotiating a solution to particular cases of double taxation are the Competent Authorities. Each Contracting State appoints one or more Competent Authority in accordance with its domestic laws. The Competent Authorities are particularly useful in relieving double taxation that occurs because the States do not agree on the facts underlying the imposition of their taxes. States may disagree, for example, on whether a particular deduction claimed by a taxpayer relates to income earned in one or the other Contracting State. In some cases, the factual dispute might arise because the taxpayer himself took inconsistent positions on the tax returns filed in the two countries as part of a plan to minimize its taxes. In many cases, the potential for double taxation arises because States do not agree on how prices should be established on transfers or other transactions between related persons. This area of issues is addressed in more detail in the Transfer Pricing Manual - see XXX.

### **3. Methods of relief from international double taxation**

19. International double taxation may be eliminated either by concession by one state, that is unilaterally (on the basis of domestic law), or bilaterally (on the basis of tax treaties) in several ways:

- Bilaterally - Allocation of exclusive taxing right to one country only - this means that the tax treaty will allow only one country to tax the particular item of income and the double taxation will be thus eliminated, because only country will tax this income. This is usually the country of residence, which will have the exclusive taxing right of a particular item of income, but it may be also agreed that certain items of income will be taxed exclusively in the country of residence - e.g. income from government employment.

Bilaterally and Unilaterally - based on the special method for elimination of double taxation - credit or exemption - described in further detail below.

Bilaterally - using the mechanism of Mutual Agreement Procedure - see further description in XXX

20. Two main methods, the exemption method and the credit method, have commonly been used to mitigate international double taxation. These methods may be applied on a unilateral basis, or within the framework of bilateral tax treaties. There are significant implications from the choice of the method for the domestic and tax treaty policy that a country should carefully consider, depending

on its economics and potential long term objectives that the country will follow. The discussion below follows an introduction of the different methods.

**(a) The exemption method**

21. Under the exemption method, a State exempts from taxation certain items of income derived by its residents in another State. It may do so in accordance with its domestic legislation or by treaty. Domestic legislation typically would grant the exemption without reference to the State where the income is generated, whereas an exemption granted by treaty would be limited to treaty States. The typical effect of the exemption method is that the State where an item of income is generated, that is, the source State, has the exclusive right to tax that item of income. As a rule, exemptions granted to residents for foreign-source income are confined by statute or treaty to profits derived through foreign permanent establishments and income from real property situated abroad or wages earned abroad. The policy goal of this limitation is to confine the exemption to income that the source State would have jurisdiction to tax, although the source State may choose to exempt the income as an investment incentive.

22. Under a variation of the exemption method, called exemption with progression, a State exempts its residents on certain income arising in another State but requires the residents to take that income into account in applying the progressive rate schedule. Assume, for example, that R is a resident of State A. R earns wages of 800 in State A and 200 in State B. Under the rate schedule applicable in State A, income below 100 is taxed at 20 per cent and income above that amount is taxable at 30 per cent. State A is required, by treaty or domestic legislation, to exempt 100 of income. In determining the tax on the remaining 900 of income, however, it is permitted to tax 900 of income at 30 per cent, just as it would have done if all of R's income had been taxable. The effect of exemption with progression is to take the exempt income into account in determining a resident's ability to pay but applying a zero tax rate to that income. The exemption with progression method has been used in many treaties, including treaties concluded by Austria, Belgium, Germany, Finland, France, Iceland, Luxembourg, The Netherlands, Spain and Switzerland.

23. States using the exemption method ordinarily do not extend the exemption to foreign dividends, interest and royalties. Many countries, however, grant special relief for domestic intercorporate dividends in order to eliminate or mitigate recurrent corporation taxation, first at the level of a subsidiary and then again at the level of the parent company. Some of these States, either by domestic law or by treaty, extend this special relief to dividends paid by a foreign subsidiary to a domestic parent. Other States do not provide this special relief. These States may be reluctant to give relief to avoid recurrent taxation when the foreign profits may not have been previously taxed anywhere. States normally do not give relief for interest and royalties because those items typically would be deductible expenses in the source State.

24. By granting a full exemption to its residents with respect to their foreign-source income, a residence State may put its foreign investors in a position of tax equality with residents of the source State. Whether this equality of position actually occurs depends on the actions of the source State. If the source State provides tax incentives targeted at foreign investors, as frequently occurs, then the foreign investors may be treated more favourably than residents of the source State. In any event, a

source State that is granting tax concessions to foreign investors favours a full exemption system on the part of the residence State because its concessions are not reduced or cancelled by the tax of the investor's country of residence. As a result, the full benefits of the concession go to the intended beneficiary, the foreign investor.

**(b) The credit method**

25. The essential feature of the credit method, whether granted unilaterally or by bilateral tax treaty, is that the residence State treats a foreign income tax paid to the source State by its residents, within certain statutory limitations, as if it were an income tax paid to itself. When the foreign tax rate is lower than the domestic rate, only the excess of the domestic tax over the foreign tax is payable to the residence State. When the foreign tax is the higher one, the residence State does not collect any tax. The effective overall tax burden is the higher of the domestic tax or the foreign tax.

26. States using the credit method reduce their normal tax claims on their resident taxpayers by the amount of the tax that those residents have already paid to the source State on profits derived from that State. The source State could thus raise its tax rate on the foreign resident to the level of the tax of the residence State without imposing an additional tax burden on the foreign resident. It must be stressed, however, that a source State may not be free to manipulate its tax rules to take advantage of this feature of the credit. For example, if the source State applied a higher tax rate on corporations residing in a State granting a credit, it might be held to have violated a non-discrimination provision in a tax treaty. In addition, a rate that discriminates against credit States might endanger the allowance of a credit if the residence State has adopted domestic legislation that disallows the credit for foreign taxes imposed in a discriminatory manner.<sup>5</sup>

27. In general, when a source State grants special tax concessions to a foreign investor resident in a State using the credit mechanism, the foreign investor has a corresponding increase in the amount of tax due to its State of residence. With some exceptions, the benefit of the concession accrues to the treasury of the resident State, not to the foreign resident. One exception applies if the source State otherwise imposes taxes at an effective rate higher than the effective rate in the residence State and the concessions merely reduce the level of taxation in the source State to the level charged by the residence State. In addition, a corporation resident in a State employing the credit mechanism may use a number of tax planning techniques to benefit from a tax concession granted in a source State. Most capital exporting States do not tax the normal business profits of a foreign affiliate of a resident corporation until the profits have been repatriated in the form of a dividend. By operating in the source State through a foreign affiliate, therefore, a resident corporation may be able to utilize a tax concession granted by the source State to indefinitely postpone any residence tax on the profits derived from the source State. In addition, the resident company may be able to utilize various tax-planning strategies for reducing its taxes that would not be available without the tax concession. A company may also benefit from tax concessions due to operation of the foreign tax credit limitation in its State of residence.

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<sup>5</sup> e.g., sec. 6 AB(6), Income Tax Assessment Act 1936 (Australia) (credit absorption tax); United States Treasury Regulation sec. 1.901-2(c) (soak-up tax); Income Tax Act sec. 126(4) (Canada).

28. Every State that grants a foreign tax credit imposes some limitations on that credit. There are many different types of limitations, some applicable to all of the income derived in a particular country (per country limitation) and some applicable to specific types of income (separate basket limitations). A common feature of those limitations is that the credit allowable with respect to the relevant category of income cannot exceed the tax that the residence State would have imposed on that income if it had been earned domestically. In computing the limitation, the residence State typically computes income according to its own concepts, not according to the tax rules applicable in the source State. As a result, limitation problems may arise from differences in the definitions of taxable income used by the residence State and by the source State. For example, assume that Company P, a resident of State A, earns 100 in State B, computed under the tax rules of State B. State B imposes a tax of 30 on that income. Under the tax laws of State A, however, Company P has taxable income of only 60, due to differences in the way depreciation deductions are calculated in the two States. If the tax rate in State A is 40 per cent, the limitation on the credit will be 24 (40% of 60). Thus, only 24 of the tax paid of 30 will be allowed as a credit, notwithstanding the fact that State B's nominal tax rate of 30 per cent is lower than the nominal tax rate of 40 per cent imposed by State A.

29. Countries applying the credit method normally deduct from their own tax only the foreign tax levied directly on the income of their residents. Assume, for example, that R, an individual resident of State A, receives a dividend of 100 from Company S, a resident of State B. State B imposes a withholding tax on the dividend of 10. State B also imposed a tax of 30 on the business profits of Company S, out of which the dividend was paid. If State A allows a credit for foreign taxes paid by its residents, it would allow Company P to claim a credit of 10 for the withholding tax imposed by State B. It would not allow a credit, however, for the 30 of taxes paid by Company S. Some States, nevertheless, do allow their resident corporations to claim a credit for taxes paid by a foreign affiliate when the profits with respect to which the tax was paid are distributed to the resident corporation as a dividend. A credit for the taxes paid by a foreign affiliate is referred to as indirect credit.

30. States may grant the credit by domestic legislation and also by treaty. The credit granted by treaty may be somewhat broader than the unilateral credit and may be fine tuned to accommodate the particular circumstances of the Contracting States. For example, a Contracting State may by treaty specify that certain taxes levied by the other Contracting State qualify for the credit, although the credit might not be allowable, or its status might be uncertain, under domestic rules. A treaty may provide that one Contracting State will grant a foreign tax credit and the other Contracting State will use the exemption method to relieve double taxation. This mix of methods typically occurs when one Contracting State grants the credit unilaterally and the other Contracting State provides exemption relief unilaterally.

31. Proponents of the credit method generally consider it to be superior to the exemption method in two respects. First, they claim that it is more effective in promoting fairness because it generally causes residents of a State to pay the same amount of income tax without reference to the source of their income. Second, they claim that the credit method promotes an efficient allocation of investment capital by treating income from foreign and domestic investment equally. The credit

method cannot overcome the unequal treatment of comparably situated taxpayers that results from the imposition of taxes in the source country at effective rates above the rate in the residence country. The exemption method, however, also is ineffective in this regard. Some commentators contend that the credit method may be more complicated to administer than the exemption method. That may be true in some respects, but it is not true in all respects. For example, use of the credit method tends to reduce the tax benefits obtained in the source country from transfer pricing abuses and from the improper allocation of deductions, thereby reducing practical complexity.

32. States that wish to use tax incentives to attract foreign investment would prefer that capital exporting States use the exemption method. Although the credit method does not eliminate the benefits of tax concessions in the source State, it may weaken the incentive effects in many cases. Because the credit method tends to reduce the impact of tax incentives on investment decisions, it also tends to reduce harmful tax competition among developing countries. States that doubt the wisdom of using tax concessions to attract foreign investment, therefore, might prefer that capital-exporting States adopt the credit method.

### **(c) Tax-sparing credit**

33. Tax-sparing credit is the practice of a residence State using the credit method of adjusting the taxation of its residents to permit those residents to receive the full benefits of tax concessions provided to them by a source State. It often takes the form of a credit (notional credit) for taxes that would have been paid but for a tax incentive. For example, assume that Company A, a corporation resident in State A, is investing and earning income in State B. State A and State B have entered into a tax-sparing agreement. Company A earns 100 in State B. Under their normal rules, State A and State B impose taxes at a rate of 35 per cent. Thus, Company A normally would owe taxes of 35 to State B. State B, however, has provided Company A with a tax holiday that reduces its taxes to zero. In the absence of the tax-sparing agreement, State A would impose a tax of 35 on Company A, thereby wiping out the benefit to Company A of the tax holiday. Under the tax-sparing agreement, State A may grant Company A a credit for the taxes that would have been paid (that have been spared) but for the tax holiday. In that way, Company A receives the intended benefits of the tax holiday.

34. In the past, some developed countries have provided tax-sparing credits in their tax treaties with developing countries. Some of the countries which historically agreed to include tax-sparing credit in some of their treaties include Canada, France, Germany, Japan and the United Kingdom. In its initial report on harmful tax competition, however, the OECD has expressed some concerns about tax-sparing agreements, due to the possibility that they foster harmful tax competition.<sup>6</sup> Some countries - e.g. the United States of America has never ratified a tax treaty that included a tax-sparing provision.<sup>7</sup> Such treaty position refusing the tax sparing credit may be based, in part, on the

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<sup>6</sup> OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998). OECD, *Tax Sparing: A Reconsideration* (1998).

<sup>7</sup> The United States of America and Brazil negotiated a tax treaty in the late 1960s in which the United States agreed to give a special tax credit for certain investment in Brazil. The United States Senate refused to ratify that aspect of the treaty, and it never went into force. Similarly, the United States' tax treaty with Pakistan, which included a tax-

principle of capital export neutrality and the principle that residents with equal taxable incomes should pay equal amounts of tax.

35. Tax-sparing credits is a practice designed to promote the effectiveness of local tax incentives for foreign investment. Developing countries are often willing to provide foreign investors significant fiscal incentives in order to encourage foreign direct investment. It is generally accepted, by developed and developing countries, that investment in productive activities is generally highly beneficial to economic growth and national wealth. As a result, States often find themselves in competition for foreign investment. Tax incentives are one way for a State to conduct that competition. Popular incentives offered by some developing countries include lengthy tax holidays, the allowance of rapid cost-recovery, including expensing of capital investments, and special tax credits for investment. States offering tax concessions to prospective investors want to maximize the potential benefits of those concessions to those investors. Tax-sparing credits is a technique for achieving that goal.

36. An evaluation of the merits of tax-sparing credits cannot be divorced from an evaluation of the tax incentives that they encourage. Proponents of tax incentives for investment in developing countries contend that the incentives are a cost-effective way of directed investment to countries badly in need of such investment. They also contend that many developing countries have few alternative methods available to them to encourage needed foreign investment. Critics of tax incentives contend that the costs of tax incentives are routinely understated and the benefits overstated. In assessing costs, they note that many countries that have employed incentives to attract foreign investment have been forced by economic and political considerations to extend the incentives to local investment as well, thereby magnifying the costs substantially. They also contend that well-managed businesses – the type that make attractive investment partners for developing countries – base their investment decisions primarily on factors unrelated to tax concessions. Finally, they contend that the overall impact of tax incentives in directing investment to developing countries is probably smaller than generally recognized, due to the widespread availability of self-help tax avoidance through the use of tax havens. For a detailed discussion of the “tax-sparing credits” mechanism, please see pages 265-268 of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (June 2001).

**(d) Implications for developing countries of the various methods for the provision of relief from international double taxation**

37. Whatever the merits of tax incentives generally, developing countries that offer tax incentives to attract foreign investment obviously want the benefits of those incentives to go to the prospective foreign investor and not to the State where that investor is a resident. In treaty negotiations, therefore, a developing country is likely to press its prospective treaty partner to provide relief for double taxation in a way that supports rather than undermines the developing country’s tax incentive programme. In theory, an exemption system or a credit system with tax sparing could be designed to support a developing country’s tax incentive programme. In practice, a

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sparing credit, was rejected by the Senate.

developing country is unlikely to have sufficient bargaining power in treaty negotiations to influence the way its prospective treaty partner provides double tax relief. If the developed country generally provides double taxation relief by using the credit method, it almost certainly will insist upon using that method in its treaty with a developing country. Similarly, a developed country that uses the exemption method is highly unlikely to switch to the credit method as a result of its treaty negotiations with a developing country. The only practical issue for negotiation is whether the developed country is willing to tailor its relief mechanism to accommodate the developing country's tax incentive programme.

38. Policy makers in developing countries have somewhat greater freedom to design tax incentives according to their own preferences if the foreign investors that they are hoping to attract are residing in a State employing a full exemption method. For those investors, the only tax that matters is the tax in the source State. Thus, the source State can design its local tax rules to have an extraterritorial impact on investment decisions made in the residence State without fear that its actions will provoke the residence State to take countervailing measures. In contrast, when the residence State is using the credit method with tax sparing, it typically grants the tax sparing credit only if it has specifically agreed to do so after negotiations with the source State. If the resident State concludes that a particular type of tax concession is unwise or contrary to its national interests, it may decline to give the tax-sparing credit with respect to that concession. Even if it ultimately agrees to give the credit, the process of negotiations may have delayed implementation of a particular tax concession for an extended period of time.

39. The flexibility that an exemption system affords to developing countries comes with significant costs. First, tax incentives may not be effective in attracting foreign investment if they are available everywhere. To attract foreign investment through tax concessions, a developing country must be able to offer the prospective foreign investor a benefit not available in other countries competing for that investment. The freedom that the exemption system gives to a particular developing country, however, is also given to all of the countries with which that country is competing. The likely result is a tax competition that benefits the foreign investor without affecting the location of its investment. Second, many developing countries have so little leverage over prospective foreign investors that they feel compelled to grant whatever tax concessions an investor demands. As a result, the control ceded by the resident State is exercised not by the source State but by the foreign investor. In general, a tax concession designed to satisfy terms set by a residence State will be more cost effective than a concession designed by the foreign investor.

40. One of the objectives of tax treaties is to strengthen the ability of States to impose taxes fairly and effectively on taxpayers engaged in cross-border activities. That purpose is defeated if a method intended to relieve double taxation promotes the elimination of all taxation. The persistent trend towards a global economy is putting pressure on all tax systems, but especially on the tax systems of developing countries. To flourish in the global economy, developing countries need to develop both their private and public sectors. They have a common interest with developed countries, therefore, in promoting measures that prevent multinational corporations from exploiting their market power and their ability to shift investments around the world to avoid a reasonable level of taxation on their profits. It is only through the cooperation of sovereign States that the sovereign power to tax can be protected from the corrosive powers of the marketplace.



41. The international efforts to deal with the problems of international double taxation, which were begun by the League of Nations and have been pursued in the Organisation for Economic Cooperation and Development and regional forums, as well as in the United Nations, have in general found concrete expression in a series of model bilateral tax conventions. In the historical evolution of these efforts, there were various tendencies, which were driven by economic and political interests of the various countries. One can clearly note the tendencies driven by the developed countries, which would focus and emphasize residence based taxation - allocating more tax revenue to the country of residence, which in case of the developed countries also happens to be the country, where the capital, know-how and expertise is located. Such allocation of taxing rights makes sense, when the economic activity takes place between two equally developed countries, because the fiscal effect should be mostly neutral on both countries. Such principles would also introduce additional simplification and reduce the compliance costs arising from the cross-border economic activities, which in itself may constitute additional burden and obstacle to cross-border business and investment. On the other hand, when the economic activities take place between unequally developed countries, the fiscal effects of rules favouring country of residence will lead to situations, when the developing country is giving up its taxing rights in favour of the other country, however due to the differences, it is likely not to benefit from a similar reciprocal measure by the other country, because the developed country is less likely to be in the position of country of source in respect of the developing country. To explore the historical background and dynamics of the tax policy issues on this matter, please see XXX

