EMERGING INTERNATIONAL TAX ISSUES

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INTRODUCTION

The purpose of this paper is to examine some emerging (and emerged) international tax issues that developing and transition countries face in the application of their income tax. The paper builds on the work done in earlier sessions during the conference particularly in relation to tax treaties. It is intended that the session be a practical session with the discussion of international tax issues developed around an extended case study. The paper contains some general discussion of the issues, but it is hoped that this will be further developed through country experiences.

In putting the case study together, I have drawn heavily on my experience in designing and drafting tax laws for developing and transition countries under the technical assistance program of the International Monetary Fund over the last 12 years. As part of this work, I have been involved in a number of tax reform projects aimed at modernising the income tax law of the countries involved. An important part of the modernisation process is the reform of international tax rules. In the global economy, there are much greater flows of capital, labour, goods and services than ever before. Income tax laws need to be redesigned to provide for more effective taxation of international transactions. The redesigned rules must ensure that there are no gaps or overlaps in the taxation of international transactions. Developing an effective regime for the taxation of international transactions starts with the domestic law. Tax treaties can then supplement the application of the domestic law.

The discussion below commences with a brief outline of the role of tax treaties in the global economy with particular reference to developing and transition countries. There then follows the case study. Essentially, the case study is designed so that the tax position can be considered as the level of economic activity of the foreign investor increases.

ROLE OF TAX TREATIES

A tax treaty is an international agreement between two or more States (referred to as “Contracting States”). Most tax treaties are bilateral and relate to the income tax. The preamble to a tax treaty sets out its purpose. A treaty provides for the avoidance of double taxation and the prevention of fiscal evasion. Tax treaties also provide for protections against tax discrimination. In their origin, the main focus of tax treaties is the avoidance of double taxation.

Tax treaties include measures to deal with the three main types of double taxation. Double taxation may arise from a residence/source conflict (both the residence and source countries taxing the same taxpayer on the same income). There are three ways in which tax treaties resolve residence/source conflicts. First, they may oblige the residence country to give relief for source country taxation properly imposed under the treaty. However, this may simply replicate the relief available under domestic law or it may involve providing greater relief (such as an exemption instead of a credit). Secondly, they may completely exclude source country taxation thereby leaving the income to be fully taxed by the residence country (e.g., royalties under the OECD Model). Thirdly, although less commonly, they may completely exclude residence country taxation thereby leaving the income to be fully taxed by the source country (e.g. government service).

Double taxation may also arise from residence/residence conflicts, i.e., both countries treat the taxpayer as a resident with the result that the taxpayer is liable for tax on worldwide income in both countries. Tax treaties resolve this conflict by including tiebreaker rules that treat a dual resident as a resident of one only of the Contracting States for the purposes of the treaty.[1]

Double taxation may also arise from source/source conflicts, i.e., both countries treat the income as sourced within their territory. Tax treaties resolve this conflict by, in effect, providing a uniform set of source rules through the defining of taxing rights under the treaty.

Because of unilateral double tax relief provisions in domestic law, it is fair to say that the main purpose of tax treaties today is not so much avoidance of double taxation but rather an “internation” sharing of revenues from international transactions. The basic structure of tax treaties is to provide unlimited residence country taxation, but to limit or exclude source country taxing rights in relation to particular items of income. Source country taxing rights are limited or excluded either through rate limits (including a zero rate) on investment income and by specifying a minimum economic connection for active income (attributable to a permanent establishment). However, if the source country has jurisdiction to tax, the residence country is obliged to recognise the source country’s taxing right by providing relief.

If the level of trade and investment between the two Contracting States is equal, the effect of limiting or excluding source taxation is to trade source jurisdiction for residence jurisdiction. What a Contracting State loses in giving up source taxing rights it gains from increased residence rights. Consequently, in this situation, the

[1] Article 4(2) and (3) of the OECD Model.

effect of a tax treaty is revenue neutral, i.e., more tax collect from residents and less from non-residents.

If the level of trade and investment is not equal (a treaty between a developed and developing country), the effect of the treaty is to transfer taxing rights from the source (developing) country to the residence (developed) country. The issue then is why would a developing country want to enter into tax treaties. The argument in favour of tax treaties is that they encourage capital inflows. They do this by providing foreign investors with certainty in the basic structure of the taxation regime applicable to the investment. Generally, treaties have priority over domestic law, although a country may be able to override its tax treaties by an ordinary Act of Parliament. Tax treaties also demonstrate to foreign investors that it is willing to "play" by the international norms. Finally, it provides certain guarantees to non-residents through the inclusion of non-discrimination clauses.

Many of the developing countries that I have worked in do not have tax treaties other than perhaps with their former colonial master. I am often asked whether the country should embark on establishing a treaty network. The difficulty with this is that it will take many years to negotiate a comprehensive tax treaty network. On average, it takes about two years to negotiate a treaty. In the global economy, having treaties with some countries and not others creates unfortunate biases. It has potential to indicate that foreign investment is only welcome from those countries with which there is a tax treaty. My advice, generally, is to reform the income tax law by internalising the basic structure of the OECD Model in the law, such as adopting the permanent establishment concept as the basis for taxing ordinary commercial income. In fact, I think that we are beginning to see the emergence of a new generation of tax treaties, namely treaties that are far more detailed than the OECD Model and that aim to more effectively connect the tax laws of the Contracting States. The recent treaties of the US with the UK and Australia are examples of this trend.

RELATIONSHIP BETWEEN TAX TREATIES AND DOMESTIC LAW

Generally, tax treaties are limiting only, in that they set out the circumstances in which a country (as source country) can tax income belonging to a resident of the other Contracting State. They do not create a liability where none exists under domestic tax law. Thus, ordinarily, if there is no taxation under domestic law, then it is unnecessary to consider the position under a tax treaty. However, some countries have provided either in their treaties or in domestic law that a broader jurisdiction to tax specified in a treaty also applies for domestic law.

Ordinarily, the structure of analysis involving a tax treaty is as follows –

(a) What is the position under domestic tax law?

(b) If there is a liability under domestic tax law, does a tax treaty limit or exclude that liability?

CASE STUDY

Software House Inc, a fiscal resident of Republica, develops and distributes shelf software (shrink wrap software) and is proposing to extend its business operations to the Equitable Republic. It is considering the following proposals –

1. Software House will advertise its software products through advertisements in computer magazines circulating in the Equitable Republic. Customers wishing to purchase software must do so on-line. The magazine advertisement refers customers in the Equitable Republic to Software House's web site. This is located on a server in the Equitable Republic. The server is owned and operated by an unrelated company, Computer Server Inc (a fiscal resident of the Equitable Republic). Software House pays a monthly fee for space on the server. The web site contains detailed descriptions of the software products available. If customers want assistance in selecting the right software, then they can correspond through the web site with a sales assistant in Republica. Once a customer has decided to purchase a particular software product, the customer clicks on the "order" icon on the web site. Customers pay for the software by providing their credit card details. Once the customer's credit card details are checked, Software House sends the customer an e-mail containing an order code that the customer can then use to download the software from the web site. At the start of the process of downloading the software, a message comes up on the screen explaining that the customer is being granted a licence to use the software subject to the condition that they do not make a copy of the software. If the customer agrees to this, then the customer clicks on the "continue" icon on the web site and the software is downloaded. Software House will have no business premises or employees of its own in your country.

2. Software House will establish a sales office in the Equitable Republic. The sales office will supply software both in CD-Rom format and through digitised delivery. Software will be copied onto CD-Roms at head office in Republica and shipped to the sales branch. The sales office will not maintain any copying equipment. The sales office will supply the CD-Roms to unrelated distributors (retail outlets) in the Equitable Republic. The office will also deliver software in digitised format direct to customers through its website. It pays a royalty to head office for each copy supplied.

A sample transaction involving the sale of an item of off-the-shelf CD-Rom is as follows. The head office's cost of producing the CD-Rom is $75. The internal transfer price to the sales office is $90. This is also the equivalent wholesale price if sold to an unrelated distributor (retail outlet in Republica). The cost of transporting the CD-Rom to the Equitable Republic is $2.50 and the sales office's selling costs are $2.50. The sales office sells to an unrelated distributor (retail outlet) in the Equitable Republic for $130. What if the sales office can sell the CD-Roms in the Equitable Republic for $85?

3. Software House will incorporate a subsidiary (Software ER) in the Equitable Republic. Software ER will be granted a licence to copy software developed by Software House onto CD-Roms or to make digitised delivery to customers. Software ER will pay a royalty for each CD-Rom copied and each copy delivered digitally. Software ER will engage in the following transactions –

   (a) Software ER will need to acquire a large item of plant for the copying of software onto CD-Roms and is considering the following financing arrangement. A financier resident in Utopia will purchase the plant and take title in Utopia. The Utopian financier leases the plant to Software ER. Under the lease, Software ER has an option to purchase the plant at the end of the lease for its residual value. Software ER has exclusive possession of the plant is liable for any damage to the plant and will be entitled to insurance proceeds in respect of such damage.

   (b) Software House subscribes for redeemable preference shares in Software ER. The terms of issue entitle Software House to a cumulative fixed rate of dividend paid in preference to ordinary shareholders. The shares may be redeemed after five years.

   (c) Software House seconds technical support personnel to Software ER. The personnel are seconded for no more than five months and continue to be paid by Software House. Software ER pays Software House a management fee for the services of the seconded personnel. The fee is equal to twice the employee's salary plus on-costs.

1. CHARACTERISATION, SOURCE OF INCOME AND E-COMMERCE TRANSACTIONS

Software House is earning income from the distribution of software to customers in the Equitable Republic. The issue is whether the Equitable Republic has jurisdiction to tax the income. The starting point is to determine whether the Equitable Republic has jurisdiction to tax under its domestic law. If it does, then the impact of a tax treaty between Republica and the Equitable Republic (if any) must be considered.

The facts state that Software House is a resident of Republica. There is nothing in the facts to indicate that Software House is also a resident of the Equitable Republic and, therefore, it is a non-resident of the Equitable Republic. As such, it is liable for tax only on income sourced in the Equitable Republic. Income sourced in the Equitable Republic may be taxed on an ordinary assessment basis (i.e., after allowing deductions for expenses incurred in earning the income) or by withholding. The source of income, method of tax and rate of tax will depend on the character of the income earned.

This part of the case study raises issues as to characterisation of income and geographic source in the context of e-commerce transactions.

Characterisation of income

The legal form of the transaction is a licence to use software rather than a sale. The software is delivered in digitised form. If the tax characterisation follows the legal form, then the income earned by Software House may be characterised as royalties (i.e., consideration for the right to use the copyright in the software) and subject to withholding tax. Alternatively, the transaction may be characterised as, in substance, a sale subject to a restriction on the use to which the software may be put and subject to assessment-based taxation.

The OECD has considered the characterisation of the income arising from the supply of software both in disk/CD-Rom form or digitised form.[2] This is relevant to the definition of "royalty" in Article 12(2) of the OECD Model Treaty. Importantly, the OECD conclusions on characterisation may also be relevant for the purposes of domestic law if the definition of "royalty" in domestic law follows the OECD Model definition.

The OECD makes a distinction between a payment for the use of the copyright in the software (royalty) and a payment for the use of the software (ordinary commercial income). According to the OECD, a payment is a royalty if it is consideration for the granting of rights to use program in a way that would, without the licence, constitute an infringement of copyright.[3] Examples include an amount as consideration for the right to reproduce and distribute software incorporating the copyrighted program, or to modify or display the program. In these cases, the payment is consideration for the exploitation of the copyright.

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[2] Paras 12-17.4 of Commentary to Article 12 of the OECD Model.
[3] Para 13.1 of the Commentary to Article 12 of the OECD Model..

The OECD regards a payment as ordinary commercial income if the rights acquired are limited to those necessary to enable the user to operate the program.[4] What is being acquired in this case is the use of the software program rather than the copyright.

There was some debate in the OECD's Technical Advisory Committee as to whether a distinction should be made between disk/CD-Rom and digitised delivery. An argument was made by some participants that a payment cannot be for a copy of the software in the case of digitised delivery because no copy exists until the customer makes a copy by downloading onto its hard drive or other non-temporary media. Since the customer makes the copy (rather than buying it off-the-shelf), it was argued that the payment is made for the right to make the copy (i.e., the payment is for the right to use the copyright). The OECD's final view is that any copy made in these circumstances is incidental to the use of the software program. The method of delivery (disk/CD-Rom or digitised) is irrelevant to the characterisation of the income.[5]

It must be emphasised that this is the OECD's position on characterisation of software payments in the context of the application of the OECD Model Treaty. Countries may well take a different view in the application of their domestic law. However, if the domestic law definition of royalties largely follows the OECD Model definition, the OECD's position of characterisation may be relevant in interpreting the domestic law definition.

Based on the OECD's analysis, the income earned by Software House is likely to be characterised, as a matter of domestic law, as ordinary commercial income and not royalties.

Source of Income

As Software House is a non-resident, it will be liable for tax only on income sourced in the Equitable Republic. The determination of source may be based on legislative rules, judicial decisions, or both. Traditionally, Anglo countries have left the determination of the source of income to the courts whereas civil law countries included detailed source rules in the tax law. In Anglo countries, the determination of source, in theory, depends on the facts of each case but, in practice, the courts have placed emphasis on particular factors in determining the source of income of particular classes of income. An issue in reforming international tax rules (particularly in Anglo countries) is whether the determination of source is left to the courts or should specified in the tax law. The advantage of specifying the rules in the tax law is certainty, but the

[4] Para 14 of the Commentary to Article 12 of the OECD Model.
[5] Para 14.1 of the Commentary to Article 12 of the OECD Model.

disadvantage is that legislative rules may be more easily manipulated. The advantage of leaving the determination of source to the courts is that it provides greater flexibility to deal with new forms of business methods or transactions as the courts can focus on the substance of the arrangements. In the global economy, it is argued that certainty in the taxation of international transactions is essential. For this reason, the trend in international tax rule development is for the legislative approach to apply to source rules.

As stated above, legislative source rules should largely follow the taxing rights set out in tax treaties as part of the process of internalising the tax treaties as part of domestic law. As the treaty rules are developed to achieve a sharing of revenues, they may need some modification to properly reflect economic connection (e.g., in the definition of permanent establishment).

If the amount derived by Software House is ordinary commercial income, there are several possible source rules that may apply. In Anglo countries, the courts begin their analysis by determining the essence of the taxpayer's business. If the essence of the taxpayer's business is contracting, the courts have regarded the income has having its origin in the contracts and, therefore, the income is sourced at the place of contract. If the essence of the taxpayer's business involves several activities, such as manufacture and sale, the income has its origin in each of those activities and, therefore, the source is apportioned among the places where those activities occur.

It is stated in the facts that Software House develops the software rather than simply dealing in it. On this basis, it may be argued that the source of the income must be apportioned between the place of development (Republica) and the place of contract for supply of the software. It is necessary, therefore, to determine the place where the contract of supply is concluded. This is based on contract law. The general principle is that a contract is concluded at the place where the acceptance of an offer is received by the offeror.[6] The formation of the contract under an internet supply will depend on the facts. Based on the facts of the case study, the following analysis may apply -

(1) The website is treated as an invitation to treat (the same as the display of goods in a shop window).

(2) The customer makes the offer to buy.

(3) The licence may constitute a counter-offer to sell.

(4) Proceeding with downloading is acceptance of the counter offer.

[6] This is subject to the "postal acceptance rule". If the acceptance is sent through the post, the contract is concluded at the place where acceptance is posted.

(5) The contract is concluded at the place where Software House receives notification of the customer's downloading. This could be the server in the Equitable Republic or Software House's computer in Republica.

Importantly, the parties to the contract have some flexibility in their negotiations to determine the place where the contract is concluded. This means that the source of the income is easily manipulated. This is always a problem with source rules based on formal acts.

Under US law, the source of income from the supply of goods is the place where the title in the goods passes. The US has not developed a special rule for internet supplies despite the fact that the passage of title is not necessarily a meaningful concept for such supplies, particularly as the risk of loss is not great because a replacement copy can be provided for little or no cost. The passage of title rule provides the parties to the supply of the software with considerable flexibility in their negotiations to agree where title passes. For example, the contract could specify that title passes at the customer's computer or the supplier's server.

Civil law countries generally use the concept of permanent establishment as the basis for taxing ordinary commercial income. As discussed above, recent tax reforms in Anglo countries have seen the treaty concepts (including permanent establishment) internalised as part of domestic law. Assuming that there is close similarity between the treaty and domestic law definitions of permanent establishment, the discussion below on the application of the OECD Model Treaty will be relevant also for the purposes of domestic law.

Application of tax treaty between Republica and the Equitable Republic

If the Equitable Republic has jurisdiction to tax under domestic law, the final issue is to consider the application of the Republica-Equitable Republic Tax Treaty. It is assumed that the treaty follows the OECD Model Treaty. It is strongly emphasised that, in absence of special rules, the application of a tax treaty is considered only if there is a liability under domestic law. If there is no domestic law liability, then, in the ordinary case, a treaty cannot create such liability.

Article 7 of the Republica-Equitable Republic Tax Treaty provides that the residence country (Republica) has the exclusive right to tax business profits unless the taxpayer has a permanent establishment in the other contracting state (Equitable Republic). If there is such a permanent establishment, the Equitable Republic can tax only the income attributable to that establishment. Thus, no matter what is the source rule for ordinary commercial income under domestic law, the rule under tax treaties is attributable to a permanent establishment.

It is necessary to first determine whether Software House has a permanent establishment in the Equitable Republic. “Permanent establishment” is defined in Article 5.

Fixed place of business

Under Article 5(1), Software House has a permanent establishment in the Equitable Republic if it has a fixed place of business in the Equitable Republic through which it carries on business. There are three conditions that must satisfied for there to be a permanent establishment under Article 5(1)[7] –

(1) There must be a place of business.

(2) The place of business must be fixed.

(3) Business must be carried on through the place of business.

Place of business

This covers any premises, facilities or installations used to carry on business.[8] In certain cases, it can include machinery or equipment.[9] The place of business must be owned, rented or otherwise available to the taxpayer. It can be the business facilities of another person. It is sufficient if a taxpayer has a certain amount of space available for use in its business activities.[10] In the context of e-commerce, there are two possible “places” that may constitute a place of business: the website and the server that “houses” the website.

A website is simply data and software and, therefore, has an electronic rather than physical existence. In the context of the case study, the website is really an electronic shop that customers access via their computers. It could be argued that Software House’s website is a place of business in the Equitable Republic as customers access the website through the use of computers in the Equitable Republic. The OECD has taken the view that physical location is essential for there to be a place of business. A website is not a place of business because it has no tangible existence.[11] Thus, a website is not a permanent establishment.

The server that “houses” a website is computer hardware. It has a physical location and, therefore, may be a place of business. However, it must be a place of business of Software House. If Software House has its own server or leases a server in the Equitable Republic, it would clearly have a place of business there.

[7] Para 2 of the Commentary to Article 5 of the OECD Model.
[8] Para 4 of the Commentary to Article 5 of the OECD Model.
[9] Para 2 of the Commentary to Article 5 of the OECD Model.
[10] Para 4.1 of the Commentary to Article 5 of the OECD Model.
[11] Para 42.2 of the Commentary to Article 5 of the OECD Model.

On the facts though, the server is owned by an unrelated person and the website is housed on the server under a “web-hosting” agreement. The OECD has taken the view that a web-hosting agreement does not give Software House a right to any particular space or control over the operation of the server.[12] It is different, therefore, from the leasing of office space. Consequently, the server is not a place of business of Software House. Based on the OECD’s interpretation, Software House would not have a place of business in the Equitable Republic and, therefore, there would be no permanent establishment under Article 5(1).

Fixed place of business

If Software House owned or leased a server in the Equitable Republic, it would have a place of business there. The next requirement is that the place of business is fixed. This may be an issue, for example, if the server is a laptop. The OECD has taken the view that what is important is not that the laptop can be moved around, but whether it is, as a matter of fact, moved around.[13] Thus, a laptop can constitute a permanent established provided its location is fixed.

Business carried on through a fixed place of business

If Software House’s server is fixed, it will constitute a permanent establishment if Software House carries on business wholly or partly through the server. The issue here is whether an enterprise can be regarded as being carried on through a purely automotive operation? The OECD contemplates that a purely automotive operation can be a permanent establishment. It gives the examples of a gaming or vending machine. However, it has been argued that the server used in internet sales is different to vending machines. While location is critical for vending machines, this is not so for the server as it can be accessed from anywhere. Thus, it is argued that an enterprise does not carry on business through a server.

Agency permanent establishment

The activities of an agent may constitute a permanent establishment of the principal. An agent (other than an independent agent) is a permanent establishment of the principal if it has and habitually exercises an authority to conclude contracts in the name of the principal. The issue in the case study is whether the activities of Computer Server Inc in the Equitable Republic constitute a permanent establishment of Software House. On the facts, there are two reasons why Computer Server Inc is not a permanent establishment of Software House. First, it is independent of Software House and is likely to host on its server websites of many companies. Secondly, it does not have any authority to

[12] Para 42.3 of the Commentary to Article 5 of the OECD Model.
[13] Para 42.4 of the Commentary to Article 5 of the OECD Model.

conclude contracts on behalf of Software House. It simply hosts Software House's website.

If the Republica-Equitable Republic Treaty follows the UN Model, it may be argued that Software House has a permanent establishment because Computer Server Inc habitually maintains in the Equitable Republic a stock of goods or merchandise from which it regularly delivers goods or merchandise on behalf of Software House.[14] The argument would be based on the idea that every time a customer downloads software from Software House's website hosted on Computer Server Inc's server, Computer Server is delivering merchandise to the customer. A person can be a permanent establishment in your country of Software House if the person habitually maintains a stock of Software House's goods or merchandise in your country for delivery. While this inclusion clearly contemplates the maintenance of a physical stock of goods, a flexible interpretation may see it adapted to the e-commerce case. The difficulty, though, is that the copy of the software is part of the website maintained by Software House and not Computer Server Inc. Even if a flexible interpretation applied, the independent agent exception is likely to apply.

Preparatory and auxiliary activities exception

If the server is a permanent establishment under Article 5(1) or Computer Server Inc a permanent establishment under Article 5(5), then the preparatory and auxiliary activities exception in Article 5(4) must be considered. The OECD regards the following activities as preparatory or auxiliary: providing a communications link between suppliers and customers; advertising; relaying information through a mirror server for security and efficiency purposes; gathering market data and supplying information.[15] For selling goods, the essential economic activity is the activity of sale; the communications tools used in the selling process should make no difference whether they are mail order, telephone/fax, or a server connecting a customer to a supplier.

If negotiations and payment are made through the server, it will be harder to argue the preparatory or auxiliary activities exception, as these are essential aspects of the activity of selling. However, customers could be directed to an ordering website located on a server outside of the Equitable Republic.

Administrative aspects

Even if the server is a permanent establishment, the Equitable Republic faces difficulties in collecting the tax. An electronic shop is different from a "real" shop, as it has no physical assets. The tax may be collected by withholding, but there is

[14] Article 5(5)(b) of UN Model.
[15] Para 42.7 of the Commentary to Article 5 of the OECD Model.

no clear class of person who can act as withholding agent. It is not feasible to require customers to withhold. Computer Server Inc does not handle any money on behalf of Software House. The only possibility is to require financial institutions to withhold based on credit card transactions. There two major problems with this. First, the financial institution is remote from the transaction and will not necessarily know whether a credit card transaction is taxable. Secondly, Software House's financial institution is likely to be outside the Equitable Republic and, therefore, it may not be possible to enforce any liable against it.

2. BRANCHES: TRANSFER PRICING AND TRIANGULAR CASES

In the second part of the case study, Software House has increased its connection with the Equitable Republic by establishing a sales office. The facts raise two issues: the allocation of income between head office and branch; and the treatment of income earned in a third country.

Transfer pricing

The case study raises two transfer pricing issues. The first is the treatment of CD-Roms imported from head office and the second is the treatment of the royalty paid in respect of digitised deliveries.

Supply of CD-Roms

In the sample transaction included in the case study, Software House makes an overall profit of $50 on the production and supply of the CD-Rom. The issue is how is this profit allocated between the head office (which developed the software and copied it onto the CD-Rom) and the sales office (which sold the CD-Rom). The starting point is to apply the domestic law of the two countries.

The sales office is a branch of Software House. It is not a separate legal person, rather the head office and sales office are part of a single entity. Consequently, the transfer between the head office and the sales office is a purely internal transaction.

Source of income

As a matter of domestic law, the issue for both countries is whether any part of the overall profit of $50 is sourced in their jurisdiction. As discussed in the first part of the case study, different countries have different approaches to the determination of the source of ordinary commercial income.

On the facts, generally, Anglo countries would require an apportionment of the overall profit between the activity of developing and copying the software in Republica and the sales activity in the Equitable Republic. This would require some qualitative judgement as the relative importance of the two activities to the generation of the profit.

The problem that can arise with this analysis is that the two countries may take a different view under their domestic laws as to the relative importance of the activities. The Equitable Republic may regard the sales activity as central to the earning of the profit and, therefore, treat most of the profit as sourced within its jurisdiction. Similarly, Republica may regard the development of the software as central to the earning of the profit and, therefore, treat most of the profits as sourced within its jurisdiction. This can lead to double taxation particularly if the credit method of relief applies in Republica (the residence country) because Republica will give relief only for that part of the Equitable Republic tax that relates to the income sourced in the Equitable Republic according to Republica's source rules.

In this class of case, the basic rule in the US is that the overall profit must be allocated 50:50 between the place of production (Republica) and the place of sale (the Equitable Republic). However, a taxpayer can elect to use an arm's length price if it can establish an "independent factory price". This is similar to the arm's length approach to profit allocation under tax treaties (see below).

In those countries, that use the permanent establishment concept as the basis for taxing ordinary commercial income of non-residents, it is likely that the treaty rules for profit allocation will apply.

Tax treaties

Article 7(2) of the OECD Model Treaty provides "the profits to be attributed to a permanent establishment are those that it would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in ordinary markets".[16] In other words, the arm's length principle is to apply. The OECD has emphasised that the starting point is the trading accounts of the permanent establishment. Tax administrations are not permitted to construct a hypothetical profit *in vacuo*, rather they are to start with the permanent establishment's business records and adjust as may be necessary to ensure arm's length pricing.

The separate entity approach required under tax treaties can conflict with the overall profit approach applicable under the domestic law of some countries. Indeed, some countries (like Australia) have been reluctant to use the separate

[16] Para 11 of Commentary to Article 7 of the OECD Model.

entity approach because it does not reflect the legal reality and may create artificial gains or losses. A particular concern is the application of the arm's length principle to give rise to a profit in one jurisdiction and a loss in the other, even though there is an overall profit. For this reason, some countries in the past have not used the separate entity approach required under tax treaties.

The OECD has countered these concerns by stating that the separate entity approach is intended as the basis for allocating the overall profit. It has emphasised that the real concern is the possibility of double taxation or non-taxation if the two countries use different methods. The approaches are illustrated below by reference to the facts of the case study.

Under the separate entity approach, the arm's length price is \$90. This is the equivalent wholesale price at the factory door in Republica. If both countries apply the separate entity approach, then \$15 of the profit (\$90-\$75) is sourced Republica and \$35 (\$130–(\$90 + \$5)) is sourced in the Equitable Republic. If Republica uses the overall profit approach, it may allocate more of the profit to Republica sources (e.g., 50:50 approach may apply). This can lead to double taxation as Republica will not give full relief for Equitable Republic tax. Similarly, if the Equitable Republic uses the overall profit approach, it may allocate less of the profit to Equitable Republic sources (again a 50:50 approach may apply). This can lead to under-taxation particularly if Republica provides double tax relief under the exemption method.

The alternative facts involve the sale of the CD-Rom in the Equitable Republic for \$85. There is an overall profit of \$5 (\$85 – (\$75 + \$5)). The concern that some countries have with the separate entity approach is that it could give rise to a \$15 (\$90-\$75) profit in Republica and a \$10 (\$85 – (\$90 + \$5)) loss in the Equitable Republic. It is submitted that this is not the intended outcome under the separate entity approach. As stated above, the intention is to use the arm's length price as the basis for allocating the overall profit. This is intended to achieve symmetry in the profit outcome between the two countries. In this example, it would be argued that the separate entity approach allocates all the profit to Republica on the basis of the arm's length price in Republica. To put it another way, based on the wholesale price in Republica, the sales activity in the Equitable Republic did not generate any profit.

Digitised delivery and royalties

It is stated in the case study that the sales office is obliged to pay a "royalty" to the head office for copy of software delivered in digitised form.

3. TAX ARBITRAGE

The final part of the case study involves Software House incorporating a subsidiary (Software ER) in the Equitable Republic. Software ER will be a resident of the Equitable Republic and, as such, will be liable for tax on worldwide income.

Tax arbitrage

"Arbitrage" is a term well known to economists meaning the profiting from price differentials in two markets for the same commodity. "Cross-border tax arbitrage" is a term of recent origin meaning the "profiting" from differences in the tax systems of two (or more) countries. International tax planning today is focussed very much on taking advantage of differences in income tax rules between countries. This is essentially a consequence of globalisation. Today, the income tax system of virtually every country has to increasingly deal with international transactions and, by their nature, international transactions potentially involve the income tax rules of at least two countries. For international tax planners, the fundamental issue is the compatibility of income tax systems, i.e., how well the income tax laws of two or more countries fit together. The work of international tax planners today involves not only ensuring that double taxation is avoided, but also chasing tax arbitrage advantages. The case study raises two common forms of arbitrage – cross-border leasing (exploiting the different tax treatment of finance leases) and financing arrangements (exploiting the different tax classifications of debt and equity).

Cross-border leasing

Cross border leases can give rise to a type of tax arbitrage referred to as "double dipping". Broadly, this is a transaction that is structured so that a single expenditure is deducted twice. The key to the tax benefit under such transactions is that the expenditure is deducted against two separate amounts of income in two countries with neither country taxing both amounts.

The case study contemplates Software ER "acquiring" plant under a finance lease. This is an arrangement legally structured as a lease but which has the same economic effect as a purchase on credit of the leased asset. Thus, under a finance lease, the lessor effectively transfers the benefits and risks of ownership of the leased asset to the lessee while retaining legal title in the asset.

Financial accounting treatment

Based on financial accounting rules, the following leases are usually treated as financial leases[17] –

[17] See, for example, International Accounting Standard 17.

(1) The term of the lease (including any period under an option to renew) is equal to at least 75% of the estimated economic life of the asset.

(2) The lease contains an option to purchase the leased asset at the end of the lease for a fixed or determinable price.

(3) The estimated residual value of the leased asset at the end of the lease is less than 20% of its fair market value at the commencement of the lease.

(4) The present value of minimum lease payments equals 90% of the fair market value of the asset at the commencement of the lease.

(5) The leased asset is custom made for the lessee and, at the end of the lease term, will have little or no value to anyone other than the lessee.

For financial accounting purposes, the lessee (and not the lessor (i.e., financier)) is treated as the owner of the asset. Consequently, the leased asset is entered in the books of the lessee as an asset. The lessor is treated as having made a loan to the lessee of the cost of acquiring the asset and the “rental” payments by the lessee are treated as payments of principal and interest on the loan. The deemed purchase price is the present value of the rental payments to be made under the lease. The interest component is calculated on the basis of the principal outstanding at the commencement of each payment period. The interest component of each payment is treated as interest expense of the lessee and interest income of the lessor.

Tax treatment

There are two approaches to the tax treatment of a finance lease. In many countries, the tax treatment follows the legal form so that all leases are effectively treated as operating leases for tax purposes. This means that the lessor is treated as the owner of the leased asset and is entitled to claim depreciation and other deductions relating to ownership of the asset. The rental payments are treated as income of the lessor and a deductible expense of the lessee.

The effect of a finance lease (as compared to an ordinary loan arrangement) is to transfer the tax benefits of ownership from the lessee to the lessor. Leaving aside international issues, why might a lessee be prepared to do that? Essentially, it can result in a lower cost of funds to the lessee. Under financial accounting, the cash flow position of the financier is the same under both an ordinary loan and a finance lease. However, the cash flow position of the financier under a finance lease changes if the financier is entitled to the tax deductions associated with ownership of the leased asset. The financier is subject to tax on the full amount of the lease payments (on the basis that it is all rental income) as compared to some apportionment of the payment as principal under a loan arrangement.

However, this is offset by the entitlement to depreciation and other deductions relating to ownership. Economically, the tax write off of the cost of the asset by the financier is the equivalent of the payment of principal under a traditional loan. If the tax write off is at a rate faster than the apportionment of the payment between principal and interest, then there are timing advantages to the financier under a finance lease as compared to an ordinary loan. In fact, it can bring about a tax position that is the inverse of an ordinary loan in that there is low taxable income (the tax deductions relating to ownership can be used to offset current tax liabilities on the financier's other sources of income) in the early years of the lease and high taxable income in the later years.

Because of competitive pressures, the cash flow advantages of the finance lease for the financier will be shared with the lessee in the form of a lower cost of funds. This will be particularly attractive to taxpayers who are not able to use immediately, or at all, the tax benefits of ownership of assets. Examples of lessees who cannot immediately use depreciation and similar deductions are those in a tax loss situation or entitled to a tax holiday. A lessee that is a tax-exempt body (such as a government instrumentality) will not be able to utilise such deductions at all. For other lessees though, the tax advantages of ownership are likely to be greater than the lower cost of funds resulting from a finance lease. In a purely domestic context, such persons are likely to prefer a traditional loan arrangement.

In some countries, the tax treatment follows the financial treatment. This can arise under specific legislative provision or through administrative or judicial principles emphasising substance over form.

Cross-border leases

A cross-border lease involves a lessor (financier) in one country and a lessee in another country. The lease is structured as a finance lease. The aim of the arrangement is to take advantage of the different tax treatment in the two countries so that both the lessor and lessee are able to claim the tax deductions relating to the cost of ownership. The lease is structured so that, in the lessor's country, it is treated as a lease for tax purposes (so that the lessor claims deductions for the costs of ownership) and it is treated as a purchase on credit in the lessee's country (so that the lessee can also claim deductions for the cost of ownership). Thus, deductions relating to the cost of ownership are claimed in both countries. These deductions are applied against the income of the lessor (financier) and against the income of the lessee. While both countries are allowing a deduction for the same costs, each country is taxing only one amount of income. So a single outlay is being deducted against two separate amounts of income by two different taxpayers in two different countries. Subject to protection against currency exchange risk, such an arrangement has cash flow advantages for both parties. In particular, the lessee gets the advantage of both a lower cost of funds plus deductions for ownership costs.

Withholding tax complication

In structuring a cross-border leasing transaction, account must be taken of the non-resident withholding tax rules in the lessee's country. If the lease is treated as the equivalent of a sale and purchase in the lessee's country, then a component of each payment by the lessee will comprise interest. As such, it may be subject to non-resident interest withholding tax. This is usually imposed at a flat rate (e.g., 10%) on the gross amount of the interest.

The imposition of withholding tax will defeat the cash flow advantages of the leasing arrangement for the lessee because the lease payments are likely to be grossed up by the tax. This is an issue for any international financial arrangement (not just leasing). The problem is illustrated by the following example. Assume a financier in Utopia borrows $100 at 9% interest and on-lends this amount at 10% to a borrower in Republica. The interest income for the financier under the borrowing is $10. As a resident of Republica pays the interest to a non-resident, it is likely to be subject to interest withholding tax. Assuming a withholding tax rate of 10%, the Republica tax payable on the interest is $1. The financier is liable for tax on a net basis in Utopia. The net profit from the transaction is $1 ($10-$9). Thus, the Republica interest withholding tax wipes out the entire net profit on the transaction. To avoid this outcome, the financier will gross up the interest charge by the withholding tax. This will result in the borrower in Republica bearing both the interest charge and the withholding tax, thereby increasing it cost of funds.

The issue for tax planners with cross border leases is how to avoid interest withholding tax in the lessee's country. Some possibilities emerge. To avoid the outcome described above, many countries exempt from withholding tax interest paid on borrowings raised on international monetary markets. This may be achieved by a simple exemption for interest paid to non-resident financial institutions or there may be detailed conditions to the exemption. Thus, if such an exemption exists, the first option is to bring the transaction within the terms of any such exemption.

Secondly, there may be a zero rate on interest in a tax treaty between Utopia and Republica. Alternatively, there may be a third country with zero rates on interest under treaties with both Utopia and Republica. The arrangement may be able to be routed through that country.

Thirdly, there may be exemptions from interest withholding tax for payments made to other bodies, such as foreign retirement funds or foreign government instrumentalities. It may be possible to do a “back-to-back” transaction using one of these entities, which may be happy to be involved for a fee.

Debt/equity classification

The second example of a tax arbitrage is the exploitation of characterisation mismatches. Broadly, this involves structuring a transaction so that the income is characterised in different ways in two countries. The most common examples of characterisation mismatches relate to the use of hybrid financial instruments (i.e., an instrument that displays some of the characteristics of equity (ownership) and some of debt). Redeemable preference shares are an example of such an instrument.

The starting point in understanding the arbitrage issues is to consider the international norms in the taxation of income from cross border equity and debt investments in companies. An equity investment (shares) in a company is an ownership interest in the company. The interest entitles the owner to a share of profits (dividend) and to the return of the investment but only after all debts have been paid. An equity holder is entitled to participate in the management of the company through the voting rights attached to the interest. A debt investment does not involve any ownership interest in the company. It entitles the holder to a fixed return (interest) based on the amount of the debt. The holder is entitled to the return regardless of the profits (if any) of the company, but the debt holder has no right to otherwise participate in profits. The holder is entitled to repayment of the debt in priority to equity holders. The holder has no rights to participate in the management of the company.

The return on an equity investment is a distribution of profits (i.e., a dividend). This is an after-tax event. In other words, the company pays tax on its profits and a dividend is paid out of the profits remaining after tax. The taxation of a dividend to a non-resident may be subject to dividend withholding tax. Thus, the profits supporting a dividend are subject to company tax and the dividend may be subject to dividend withholding tax.

The return on a debt investment is interest. This is an ordinary business expense deductible to the company. The payment of interest to a non-resident is subject to withholding tax. Because of the deductibility of interest, the profits supporting the interest are only subject to withholding tax in the source country. Thus, the source country taxation of interest is much lighter than the taxation of dividend.

However, to complete the tax position it is necessary to also consider the residence country taxation. The taxation of a dividend from a related foreign company is may be exempt from tax in the residence country (at least to the extent to which it is paid out of active income). This is referred to as the participation exemption. Alternatively, the foreign tax credit system including the indirect credit (i.e., a credit for the foreign corporate tax on the profits supporting the dividend) may apply. The combination of the indirect credit for underlying tax and the dividend withholding tax is likely to equal or exceed the residence country tax on the dividend so that there is little or no further taxation of the dividend. On the other hand, interest is fully taxable in the residence country with a credit for the foreign withholding tax.

A pattern of taxation emerges. A cross border equity investment is primarily taxable in the source country. The company is liable for tax on its profits and a dividend paid after tax to a non-resident shareholder may be subject to dividend withholding. The dividend may be exempt from tax in the residence country, or a credit allowed for the combined company and withholding tax – in either case there is little or no residence country. A cross border debt investment is primarily taxable in the residence country. Because of the deductible of the interest in the source country, the only source tax is withholding tax, which may be at a low rate (or even a zero rate under a tax treaty). The interest is fully taxable in the residence country.

Given this treatment, tax planners may seek to use a financial instrument that will be treated as a debt in the source country and equity in the resident country. This is possible because, as stated above, some financial instruments display features of both equity and debt. These are referred to as hybrid instruments. As with finance leases, some countries follow the legal form of the instrument, while other countries follow the economic substance of the instrument. Redeemable preference shares in the case study are an example of a hybrid instrument. The legal form of the instrument is a share (i.e., equity), however, the shares carry the right to a fixed dividend that is cumulative (i.e., carried forward to the next period if insufficient profits to pay it) and the right to redemption after five years – these are common characteristics of debt.

The issue concerns the characterisation of the “dividend”. Is it a dividend or interest? If the source country characterisation is based on economic substance, the redeemable preference shares may be treated as debt. As such, any dividends paid will be characterised as interest. The payer company will be entitled to a deduction for the “deemed interest” and it will be subject to withholding tax (if any). If the residence country characterisation follows legal form, the shares will be treated as equity, the dividend may be entitled to the participation exemption. Thus, the characterisation results in little or no taxation of the dividend. To achieve the arbitrage, therefore, the dividend must be characterised as interest in the source country (based on economic substance) and as a dividend in the residence country (based on legal form).

4. MANAGEMENT FEES AND SECONDED EMPLOYEES

Software ER pays a management fee to Software House as consideration for the technical services provided by employees of Software House. The employees are posted to Software ER for periods of up to 5 months. They continue to be paid their remuneration by Software House.

Management fees

The starting point in establishing the Equitable Republic's jurisdiction to tax the management fees is domestic law. The issue is whether the fee has a source in the Equitable Republic. The source of management fees may be based on the location of the services to which the fee relates or the residence of the payer. On the facts, under either source rule, the fee will have an Equitable Republic source. Some countries impose withholding tax on management fees.

If there is jurisdiction to tax under domestic law, it is necessary to consider whether a tax treaty (if any) between Republica and the Equitable Republic impacts on this liability. A management fee is business profits and, therefore, the Equitable Republic will have jurisdiction to tax only if the fee is attributable to a permanent establishment of Software House in the Equitable Republic. If there is no permanent establishment, then there is no jurisdiction to tax. Thus, the critical issue is whether Software House has a permanent establishment in the Equitable Republic.

The existence of a subsidiary is not of itself a permanent establishment of the parent company (article 5(7) of the OECD Model). However, if the seconded personnel are utilising an office or other space of Software ER on an on-going basis, there is a strong argument that the space is a permanent establishment of the Software House. There is no requirement that the employees use space owned or leased by Software, simply having space available for use by Software House's employees is sufficient. If there is a permanent establishment, the Equitable Republic can tax the fee. However, it must allow a deduction for the remuneration paid to the employees and on-costs.

Remuneration of seconded employees

The seconded employees are present in the Equitable Republic for no more than five months. This would not be sufficient to constitute the employees a resident of the Equitable Republic. As non-residents, the employees will be liable for tax only on income sourced in the Equitable Republic. The usual source rule for remuneration is place of performance. On the facts, this is in the Equitable Republic. Thus, under domestic law, the Equitable Republic is likely to have jurisdiction to tax the remuneration.

Tax treaties permit source countries to tax remuneration of residents of the other Contracting State provided the employment is exercised in the country. However, there is an exception for remuneration arising from certain short-term assignments.[18] The exception applies if three conditions are satisfied –

(1) The employee must be present in the source State for a period(s) not exceeding 183 days. This is satisfied on the facts as each assignment is for no more than five months.

(2) The remuneration must be paid by a non-resident of the source State. This also is satisfied on the facts as Software House is a non-resident of the Equitable Republic.

(3) The remuneration must not borne by a permanent establishment of Software House in the Equitable Republic. This is the critical issue on the facts. The question of whether Software House has a permanent establishment has been discussed above. If it does, then the remuneration is taxable in the Equitable Republic. This ensures symmetry in that the Equitable Republic is taxing as income amounts allowed as a deduction to the permanent establishment.

[18] Article 15(2) of the OECD Model.