

An Introduction to International Taxation

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Introduction

The current international tax regime is a flawed miracle.¹ It is a miracle since taxes are the last topic on which one would expect sovereign States to reach a consensus upon since in international taxation, one country's gain in revenue is another's loss. Nevertheless, a coherent international tax regime exists that enjoys nearly universal support. This international tax regime was first developed in the 1920s, when the League of Nations first undertook to study ways to avoid international double taxation, and has been embodied both in the model tax treaties developed by the Organisation for Economic Co-operation and Development (OECD) and the United Nations and in the multitude of bilateral treaties that are based on those models.² The existence of the regime shows that inspite of the sovereign rights of each State to determine its own taxation policies, a universally acceptable regime that will be followed by majority of the countries can be arrived at.

However, the miracle is flawed. The current regime suffers from significant weaknesses, as after the rise of the MNCs the principles that were agreed upon in the 1920s and 1930s have in effect become obsolete. With the advent of the era of globalisation and the development of technology, the movement of capital has become completely free and the Trans National Corporations (TNCs) have experienced a colossal rise. Consequently, with the rise of MNCs, questions such as which State should tax which income and how should it be taxed, have warranted a great deal of attention and thinking.

In this article I endeavor to provide to a common man's guide to international taxation and along with it discuss certain contemporary questions which have arisen.

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¹ Reuven S. Avi-Yonah, "*The Structure Of International Taxation: A Proposal For Simplification*", 74 Tex. L. Rev. 1301, *1304-1305

² See, Organization for Economic Co-operation and Dev., Model Tax Convention on Income and Capital, 1 Tax Treaties (CCH) P 191 (Sept. 1, 1992) United Nations Dep't of Int'l Economic & Social Affairs, United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102 Internal Revenue Service, U.S. Treasury Dep't Convention Between the United States of America and _____ for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, 1 Tax Treaties (CCH) P 211 (June 16, 1981)

Which State Should Levy Tax? - Jurisdiction to Tax

Every State has the sovereign right to impose tax, whether it be the State where the income is generated) or the State where the taxpayer resides, the former called as the ‘source country’ while the latter ‘residence country’.

In the international taxation regime, though the State which has the ‘source jurisdiction’ is granted the prior right to tax all income and the State which has the ‘residence jurisdiction’ has the primary obligation to prevent double taxation, it is only a concession to the source State’s ability to impose taxes first as the income is generated in that State and it does not reflect the optimal allocation. Optimally, the active business income (generally derived from economic activities under the taxpayer's direct control; in the international sphere, this income is derived from “foreign direct investment”) should be taxed in the country in which it originates (i.e. source country) and passive income³ (income such as income from dividends, interest, and royalties) should be taxed in the residence country.⁴ Ultimately, the allocation of income is determined by the tax treaties between the Contracting States. The allocation, however, is based on the principles of source jurisdiction and residence jurisdiction and distinction between passive income and active income.

³ Passive income, .. is frequently derived from activities in which the taxpayer has only a very small degree of voting control, such as a small shareholder in a corporation or an unrelated lender with voting control. However, passive income (in the sense of distributions of a firm's earnings) may also be earned by persons who control the underlying operations, such as a controlling shareholder who is paid dividends or interest by her corporation Reuven S. Avi-Yonah, “*The Structure Of International Taxation: A Proposal For Simplification*”, 74 Tex. L. Rev. 1301, *1307-1308

⁴ See Hugh J. Ault, Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 47 Tax L. Rev. 565, 565 (1992). If the entire world income can be divided between ‘source’ and ‘residence’ countries and taxed accordingly, double taxation or undertaxation will be avoided since through the treaties the States would decide as to which income will be taxed by which State and to what extent. However, the tax treaties do not completely achieve their goal of dividing the worldwide taxing jurisdiction between source and residence countries since – 1) not all business income is taxable primarily in the source country i.e. if the income is not attributable to a permanent establishment of a business operation it will not be taxable by the State. 2) taxation of passive income at its source is not completely abolished, but it is reduced in most treaties to the lowest possible levels. For example, the 1992 OECD Model Income Tax Treaty recommends tax rates of 5% to 15% on dividends, 10% on interest, and 0% on royalties. Hence even if there is an optimum division between all States; there might be some amount of double taxation or undertaxation. See Reuven S. Avi-Yonah, “*The Structure Of International Taxation: A Proposal For Simplification*”, 74 Tex. L. Rev. 1301

A typical tax treaty reflects a distinction between active and passive income. It firstly defines what constitutes an active business operation in a given country (in international taxation context it's what constitutes "permanent establishment"⁵) and gives the source State the primary right to tax the profits from that business operation.⁶ The treaty also provides that the residence country is required to exempt those profits from tax, at least to the extent they were taxed by the source country. The tax treaty also tries to reduce the taxes levied by the source country on passive income derived within it, leaving the right to tax that income to the residence country.⁷

In case of individuals, there are several grounds for preferring residence over source taxation. One ground is that the individuals can only be in one place at any given time as a result of which residence for individuals is a relatively easy concept to establish. Whereas on the other hand, determining the source of income is a highly difficult venture, as in most cases, income will have more than one source. In case of MNCs residence cannot be determined as in the case of individuals and also residence taxation will result in more revenues being collected by developed countries as compared to the developing countries. Hence, residence taxation is preferable in case of individuals whereas source taxation or a combination of source taxation and residence taxation (permanent establishment) is preferable in case of MNCs.

The most significant issue concerning source-based taxation of active income involves the proper method of allocating the taxable income of MNEs among taxing jurisdictions i.e. how an MNC which has a presence and generates income from different parts of the world be taxed. This has been the subject matter of a debate going on since decades and this debate leads us to the next concept of transfer pricing.

⁵ The OECD model treaty defines permanent establishment as "a fixed place of business through which the business of an enterprise is wholly or partly carried on," including the location of management, a branch, an office, a factory, a workshop, a building site or an installation project lasting more than 12 months. Oleksandr Pastukhov, "International Taxation Of Income Derived From Electronic Commerce: Current Problems And Possible Solutions" 12 B.U. J. Sci. & Tech. L. 310, *318-319

⁶ Reuven S. Avi-Yonah, "The Structure Of International Taxation: A Proposal For Simplification" 74 Tex. L. Rev. 1301, *1307-1308

⁷ See Articles 10-12 of Organization for Economic Co-operation and Dev., Model Tax Convention on Income and Capital, 1 Tax Treaties (CCH) P 191 (Sept. 1, 1992); United Nations Dep't of Int'l Economic & Social Affairs, United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102

Transfer Pricing

Currently transfer pricing issues account for majority of the major tax cases worldwide than all other tax issues put together. Transfer pricing refers to the prices that related parties charge one another for goods and services passing between them.⁸ For example, if a company 'X' manufactures goods and sells them to its sister concern 'Y' in another country, the price at which the sell takes place is known as the transfer price. The most common application of the transfer pricing rules is the determination of the correct price for sales between subsidiaries of a multinational corporation or within the same corporate group. These prices can be used to shift profits to preferential tax regimes or tax havens. If, a subsidiary in a high-tax jurisdiction charges a price below the "true" price (i.e. it transfers at a price below the actual price), some of the group's economic profit is shifted to the low-tax subsidiary, as a result of which the assessee is able to escape tax or mitigate it but at the same time the tax base of high-tax jurisdiction is eroded.⁹ Hence, unless prevented from doing so, corporations or other related persons engaged in cross border transactions can escape from paying tax by manipulating the transfer prices. For example, suppose the only transaction between a holding company and a subsidiary company in a different country involves the holding company's transfer of manufactured goods at a price equal to the cost price of Rs. 600 each, and the subsidiary resells it for Rs. 1200 each, and if the tax rate of the subsidiary company's country is lower or zero, then the holding company can easily escape payment of tax. Hence most countries have transfer pricing rules which regulates the prices charged by related persons. The main aim of an effective transfer pricing regime is to enable MNEs and revenue authorities, with minimum expense and difficulty, to divide taxable business income among the countries in which they operate. Most systems, including the U.S. transfer pricing rules, follow the arm's length principle which has been discussed below.

A.9 of the OECD Model Treaty provides that the transfer prices should be regulated so that they would reflect transfer prices that would have been set between unrelated enterprises acting

⁸ Brian J. Arnold & Michael J. McIntyre, "*International Tax Primer*", Second edition, Kluwer Law International, The Hague, The Netherlands, 2002, p.55

⁹ See Elizabeth Chorvat, "*Forcing Multinationals To Play Fair: Proposals For A Rigorous Transfer Pricing Theory*", 54 Ala. L. Rev. 1251

independently. This is known as the arm's-length method and has been embodied in most in most tax treaties, including the model treaty issued by the United Nations. It involves treating each constituent unit of a MNE, which can be a subsidiary or a branch, as a separate taxable entity and reconstructing its income, based on hypothetical transactions that would have taken place had the unit been dealing with other portions of the MNE at arm's length.¹⁰ In other words the underlying principle is that the prices charged by related parties (mostly units of an MNC) to one another should be consistent with the price that would have been charged if both parties were unrelated and negotiated at arm's length.¹¹

However, the wide acceptance of the arm's length method masks the disagreement over the way the method should be applied in practice as various methods have been formulated by which the standard can be applied. In case of Tangible Property the following are the specified methods – 1)Comparable Uncontrolled Price Method, 2)Resale Price Method, 3)Profit Split Method, 4)Comparable Profits Method , 5)Cost Plus Method.

a. Comparable Uncontrolled Price Method

The comparable uncontrolled price (“CUP”) method evaluates whether the amount charged in a controlled transaction (i.e. transaction between related parties such as that between a holding company and a subsidiary company or between two subsidiary companies) is arm's length by reference to the sales of similar products made between unrelated persons in similar circumstances. For example if ‘A’ is a company established in country ‘X’ manufactures cupboards at the cost of Rs.1000 and sells them to unrelated distributors at R. 1500. It also sells the same cupboards to its subsidiary company in another country which resells it at Rs. 2000. If the circumstances of sale are similar, then the arm's length price for the subsidiary company will be Rs. 1500 and the profit will be Rs. 500 (2000-1500) of the subsidiary company. However, the taxpayer must establish that the

¹⁰ “*The Structure Of International Taxation: A Proposal For Simplification*” Reuven S. Avi-Yonah 4 Tex. L. Rev. 1301, *1340-1341

¹¹ See “*Modern Financial Theory And Transfer Pricing*”, Robert Ackerman and Elizabeth Chorvat, 10 Geo. Mason L. Rev. 637

products, contractual terms, and economic conditions of the controlled transaction bear a close similarity to the uncontrolled transaction (i.e. transaction between unrelated parties).¹²

b. Resale Price Method

The resale price method measures an arm's length price by subtracting the appropriate gross profit from the price at which the goods are ultimately sold to unrelated parties. If suppose, in the above example the subsidiary company is only engaged in reselling the goods (i.e. it does nothing else but receive the goods from the holding company and resell it), then the resale price method is an appropriate method of computing the arm's length price.

c. Cost Plus Method

The cost plus method is ordinarily used in situations involving the manufacture, assembly, or other production of goods sold to related parties. It uses the manufacturing cost as its starting point and adds the appropriate gross profit to the cost of manufacturing the goods of the related seller.¹³

d. Comparable Profits Method

The Comparable Profits Method (CPM) evaluates whether the results in a controlled transaction are arm's length, based on objective measures of profitability derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Under CPM, the taxpayer must establish, for itself or a related party, an arm's length range of profits on a set of transactions and if the tested party's reported profits on those transactions fall within that range, then its transfer prices will be accepted by authorities. However, if its profits fall outside that range, the tax authorities may adjust transfer prices so that profits fall within that range.¹⁴

¹² “*International Transfer Pricing*”, Mark R. Martin, 44-AUG Hous. Law. 24, *26-27

¹³ This gross profit is determined by reference to the gross profit percentage earned by the seller with unrelated parties or by comparable unrelated parties in transactions with unrelated parties. Brian J. Arnold & Michael J. McIntyre, “*International Tax Primer*”, Second edition, Kluwer Law International, The Hague, The Netherlands, 2002, p.62

¹⁴ See “*Modern Financial Theory And Transfer Pricing*”, Robert Ackerman and Elizabeth Chorvat, 10 Geo. Mason L. Rev. 637

e. Profit Split Method

In this method the worldwide taxable income of related parties engaging in a common line of business is computed, thereafter which it is allocated amongst related parties in proportion to the contribution they are considered to have made in earning the income. This method is normally applied when the above methods cannot be applied. In case of a group of affiliated companies having more than one product line, the profit split method might be applied separately to each product line. A distinctive feature of this method is that it applies to aggregate profits from a series of transactions and not to individual transactions.¹⁵

Different methods are applied according to different circumstances as certain methods are apt for certain situations.

Whereas in case of intangible property the following are the specified methods –(i) the comparable uncontrolled transaction method; (ii) the CPM discussed above; and (iii) the profit split method¹⁶

However, there are certain problems with the arm's length standard – 1) determination of a transfer price under the standard is often truly hypothetical since comparable actual transactions rarely exist. 2) The potential still remains for manipulating the geographical source of income by adjusting the transfer prices. It is very easy to establish a permanent establishment as the threshold for the same is very low. Hence it's very easy to escape tax by establishing a permanent establishment and by manipulating the transfer prices. The incentive to set transfer prices for favorable tax consequences is even greater when the tax rates of the countries involved differ substantially or the country is a tax haven. 3) Each of the two countries having jurisdiction to tax

¹⁵ Brian J. Arnold & Michael J. McIntyre, "International Tax Primer", Second edition, Kluwer Law International, The Hague, The Netherlands, 2002, at p.66-67

¹⁶ See "*International Transfer Pricing*", Mark R. Martin, 44-AUG Hous. Law. 24, for a detailed explanation of the methods.

might determine different transfer prices for the same transaction. If there is no mechanism for coordination, double taxation may be the result.¹⁷

The United States and the OECD were closely scrutinising transfer prices due to the problems inherent with the practical application of the arm's length standard to transfer pricing.¹⁸ However since the arm's length approach is so deeply embedded in the OECD Model Tax Conventions and other methods such as formulary apportionment¹⁹ were considered to be arbitrary and unworkable, alternatives were not considered.

¹⁷David M. Hudson Daniel C. Turner, “*International and Interstate Approaches To Taxing Business Income*”, 6 Nw. J. Int'l L. & Bus. 562, *580-581

¹⁸“In 1981, the Comptroller General of the United States issued a report concluding that 'the theory on which [the arm's length approach] rests no longer corresponds to the realities of intercorporate transactions.' The report recommended that consideration be given to reformulating section 482 regulations to permit formula apportionment as an alternative to the separate-accounting/arm's-length approach. The Commissioner of the Internal Revenue, however, brushed aside this recommendation of the report, suggesting that the United States is in good company with the O.E.C.D. in retaining the arm's length standard. In Europe, the OECD studied the problems of transfer pricing, and issued a report in 1979. Because the arm's length approach is so deeply embedded in the OECD Model Tax Conventions, the report did not consider alternatives; its objective being 'to set out as far as possible the considerations to be taken into account and to describe, where possible, generally agreed practices in determining transfer prices for tax purposes.' The report did note in passing, however, its awareness of proposals for formulary apportionment, but the report rejected this method as arbitrary and unworkable. The report deemed the method to be arbitrary because it disregarded both market conditions, and an enterprise's circumstances and allocation of resources. The report believed that formulary apportionment was unworkable in practice, because taxing authorities, especially of a foreign country, would not have access to information concerning the world-wide activities of a transnational enterprise.” David M. Hudson Daniel C. Turner, “*International and Interstate Approaches To Taxing Business Income*”, 6 Nw. J. Int'l L. & Bus. 562, *582-583

¹⁹ Formulary method treats the entire MNC as one unit and then seeks to apportion its income among tax jurisdictions based on a formula.

Harmful Tax Competition

Increase in globalisation and opening up of markets has resulted in rising of special tax regimes and practices aimed to attract more capital inflows and tax base from other jurisdictions, leading to an harmful tax competition. Though lowering of tax rates and broadening of tax bases is a healthy tax competition and is encouraged by OECD since it eliminates wasteful & inefficient tax preferences.²⁰

Tax competition is the nation's relinquishment, in whole or in part, of its right to tax an economic activity, with the result that its effective tax is less than that of other countries.²¹ Reduced taxation is indulged in to attract the allocation of capital and business activities on an assumption that it increases the domestic public welfare. However, the host country ignores the fact that the same will have a negative effect on the welfare of other countries, which makes the tax competition harmful. The loss of tax revenue results in fewer public benefits, reallocation of goods and services and redistribution of wealth becomes difficult, higher incidence of tax on less mobile factors such as labour. The OECD justifies its intervention since the domestic tax regime involving in harmful tax competition has a negative impact on the tax system of other countries.

Harmful Tax Competition is considered to be a race to the bottom since, if a country seeks to attract foreign investment by offering preferentially generous tax treatment, some other country might compete for the same investment by offering even more generous treatment; the first country might respond by offering treatment more generous still and so on and so on, until the benefit of attracting the investment has been reduced to zero. Indeed, the country which succeeds in attracting the investment might even suffer a loss because it might find itself permitting the foreign investor to benefit from its expenditure (on, for example, infrastructure and education) without charge. If this

²⁰ Hugh J. Ault, "Tax Competition: What (If Anything) To Do About It?", International and Comparative Taxation, Essays in Honour of Klass Vogel, Kluwer Law International, U.K., 2002, p.2

²¹ See David M. Hudson Daniel C. Turner, "International and Interstate Approaches To Taxing Business Income", 22 Nw. J. Int'l L. & Bus. 161, *191

is so, the preferential regime, far from generating growth, will function so as merely to permit the foreign investor to exploit the host country.²²

The developed nations have become concerned over the effects of globalisation on their tax regimes. Due to the increase in the mobility of capital, financial services, and skilled labor, many developed nations see certain tax practices of other countries as unfairly attracting the economic activity that would otherwise have taken place within developed countries, causing an erosion “of the tax base of these countries.”²³ The European Union and the Organisation for Economic Cooperation and Development (“OECD”) have adopted initiatives to counteract the practices perceived by them as harmful tax competition. The object of both the organisations is to eliminate the tax provisions and regimes which are harmful to its members.²⁴ In the 2000 OECD report, sixty-one member country preferential regimes were identified and thirty five countries were identified as tax havens. The OCED has constituted a subsidiary body called as “Forum on Harmful Tax Practices”, to administer the guidelines under the report. Under the report the member countries of the OECD have agreed to undertake a self-review of their own domestic measures and eliminate within a stipulated period those found harmful. Also “peer review” process is agreed upon whereby the country can ask the Forum to review measures of another country and to give its opinion, though only a recommendation and is not legally binding, but substantial peer pressure can ensure compliance.²⁵

Tax Havens and Harmful Preferential Tax Regimes

²² Michael Littlewood, “*Tax Competition: Harmful To Whom?*”, 26 Mich. J. Int’l L. 411, *449

²³ David M. Hudson Daniel C. Turner, “*International and Interstate Approaches To Taxing Business Income*”, 22 Nw. J. Int’l L. & Bus. 161, *165-166

²⁴ While EU is only concerned with the activities of its member States, the OECD is concerned with the activities of the member as well as the non-member States.

²⁵ See Hugh J. Ault, “*Tax Competition: What (If Anything) To Do About It?*”, International and Comparative Taxation, Essays in Honour of Klass Vogul, Kluwer Law International, U.K., 2002

A tax haven is essentially a jurisdiction which serves as a means by which firms and individuals resident in other jurisdictions can escape the taxes that they would otherwise be obliged to pay there.²⁶ The OECD Report on Harmful Tax Competition deals with tax haven explicitly since there is a clear perception that there has been a great deal of loss of tax base by Member countries, especially in financial service areas, by tax havens. The Report proposed that tax havens should be identified principally by reference to four “key factors” as follows: 1) no or only nominal taxes (generally or in special circumstances) 2) laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction 3) lack of transparency 4) the absence of any requirement for substantial activity.

Low or only nominal taxation, combined with a situation where the jurisdiction offers or is perceived to offer itself as a place where non-residents can escape tax in their country of residence could be “sufficient to identify a tax haven.”²⁷

A preferential tax regime is a targeted tax regime wherein, the country might operate a “normal” tax system, but exempt specified classes of income from tax or subject them to tax at lower rates (the tax incentives with which developing countries seek to attract foreign investment are, thus, preferential regimes). The OECD report on harmful tax competition stated four key factors and eight other factors as identifying factors of a harmful preferential tax regime. The four “key” factors were as follows: 1) a low or zero effective tax rate on specified kinds of income 2) “ring-fencing” 3) lack of transparency 4) no effective exchange of information with other governments. The eight “other” factors were as follows: 1) an “artificial” definition of the tax base 2) a failure to adhere to international transfer pricing principles 3) the exemption of foreign-source income from tax 4) negotiable tax rates or tax bases 5) the existence of secrecy provisions 6) access to a wide network of tax treaties 7) the promotion of the regime as a tax minimization vehicle 8) the encouragement by the regime of purely tax-driven operations or arrangements.²⁸ The essential

²⁶Michael Littlewood, “*Tax Competition: Harmful To Whom?*” 26 Mich. J. Int'l L. 411

²⁷ OECD, Harmful Tax Competition: An Emerging Global Issue (1998), at <http://www.oecd.org/dataoecd/33/0/1904176.pdf>

²⁸ Michael Littlewood, “*Tax Competition: Harmful To Whom?*”, 26 Mich. J. Int'l L. 411 * 423-424

difference between a tax haven and a harmful preferential regime is that a tax haven does not have any tax base to protect and does not have any interest in preventing harmful tax competition which is not the case with harmful preferential tax regimes.²⁹

Many developments have contributed to the growth of tax havens, including: 1) improved financial services, transportation, communications including emergence of e-commerce as a result of which capital and economic activities has become more mobile 2) liberalization of cross border investment and trade 3) strict bank secrecy and confidentiality requirements.³⁰

Tax havens and similar preferential tax regimes remove the effects of the economic laws by insulating themselves from the effect of FDI and non-resident business. It is accomplished principally in two ways: by ring fencing and by requiring the business enterprises to transact in foreign currency only. Ring fencing is the process of restricting the non-resident enterprises from entering in to the domestic market or competing with the domestic enterprises. As a result of this, the serious economic consequences of competition are eliminated. Further, tax havens protect themselves from the adverse economic effects of FDI by requiring the business enterprise to conduct its affairs in foreign currency only. Usually the laws require that FDI, incomes, and expenditures (except for small amounts for local purposes) be carried out in a currency other than that of the havens, as a result of which the haven's essential economy is not affected by increasing imports or increasing the currency value.

It is an assumption that the Tax Havens seek to gain not from levying tax but by the employment, infrastructure, technological knowhow and other such benefits that are brought by MNCs. However, the damage done by havens to “real economies” is huge in relation to the benefits the havens gain in terms of job and infrastructure. The ultimate beneficiary of the havens is the investor or the “domestic tax avoider” who is able to avoid the imposition of taxes by the home country by taking the shelter in the host haven country.

²⁹ See Brian J. Arnold & Michael J. McIntyre, “International Tax Primer”, Second edition, Kluwer Law International, The Hague, The Netherlands, 2002

³⁰ Ibid at p. 137

The OECD requires the tax havens (1) to ensure that their tax systems are transparent and (2) to provide for the effective exchange of information. Any jurisdiction satisfying these two criteria will not be classified as uncooperative. In its 2001 Report, the Committee elaborated on both of these requirements. The OECD observed that by committing to transparency, a jurisdiction agrees that there will be no non-transparent features of its tax system, such as rules that depart from established laws and practices within the jurisdiction, “secret” tax rulings or the ability of persons to “negotiate” the rate of tax to be applied. Transparency also requires financial accounts to be audited or filed. A committing jurisdiction also agrees that its governmental authorities should have access to beneficial ownership information regarding the ownership of all types of entities and to bank information that may be relevant to criminal and civil tax matters. As regards the exchange of information, the OECD observed: By committing to effective exchange of information, a jurisdiction agrees to establish a mechanism for the effective exchange of information that includes the following elements. The commitment ensures that there is a legal mechanism in place that allows information to be given to a tax authority of another country in response to a request for information that may be relevant to a specific tax inquiry. An essential element of effective exchange of information is the implementation of appropriate safeguards to ensure that the information obtained and provided is used only for the purposes for which it was sought. The adequate protection of taxpayers' rights and the confidentiality of their tax affairs are essential to preserving the integrity and effectiveness of exchange of information programs In the case of information requested for the investigation and prosecution of a criminal tax matter, the information should be provided without a requirement that the conduct being investigated would constitute a crime under the laws of the requested jurisdiction if it occurred in that jurisdiction. In the case of information requested in the context of a civil tax matter, the requested jurisdiction should provide information without regard to whether or not the requested jurisdiction has an interest in obtaining the information for its own domestic tax purposes.³¹

³¹Michael Littlewood, “*Tax Competition: Harmful To Whom?*”, 26 Mich. J. Int'l L. 411, *436

Double Taxation

As has been stated earlier, every country has the sovereign right to tax income accruing, arising or received in it, on account of the activity carried on in its territory. If every nation resorts to tax and if the activities are carried on in two or more than two countries, the same income gets taxed in all the countries and it results into double taxation. A mixture of the residence and source principles of taxation also may result in double taxation by two countries of the same income (if only one principle would be applied by the countries worldwide, then double taxation would not have been a consideration. However countries mostly apply a mixture of the two principles and not a single principle).³² Further, an export of one country is by its very nature, an import of another country. Thus the possibility of double taxation is very real. Double taxation has a cascading effect on the cost of operations and effectively acts as a hindrance to cross border investments, trade, commerce and services. Hence it's necessary to avoid double taxation.

The principle underlying avoidance of double taxation is to share the revenues between two countries. If each country gets its share of tax revenues, the bilateral and multilateral trade grows and the overall tax collection also increases as a result of which both countries tend to benefit.³³ Double taxation is frequently avoided through a Double Taxation Avoidance Agreement (DTAA) entered into by two countries for the avoidance of double taxation on the same income. The DTAA eliminates or mitigates the incidence of double taxation by sharing revenues arising out of international transactions by the two contracting states to the agreement. DTAA generally allocates taxing jurisdiction of the relevant item of income on the source or resident country or both, stipulates the maximum (ceiling) rate of tax on the income and thereby provides relief from double taxation. The DTAA is based on four basic models of DTAA and they are – OECD Model Tax Convention (emphasis is on residence principle), UN Model (combination of residence and source

³² N.K.Bhat, "*Overview of International Taxation*", International Taxation – A Compendium, The Chamber of Income Tax Consultants, fifth edition, 2005

³³ *Ibid*

principle but the emphasis is on source principle), US Model (it's the Model to be followed for entering into DTAA's with the U.S. and its peculiar to the US) and the Andean Model (model adopted by member States namely Bolivia, Chile, Ecuador, Columbia, Peru and Venezuela).

Methods for Preventing Double Taxation

There are three methods of providing relief from double taxation – exemption method (the residence country exempts income that has arisen in the source country), credit method (the residence country grants credit for taxes paid by its resident in the source country) and the deduction of foreign taxes method (the residence country allows its taxpayers to claim a deduction for taxes paid to a foreign government in respect of foreign source income). Mostly the credit method is adopted in the DTAA for providing relief from double taxation.³⁴

Each of the three unilateral methods for preventing double taxation discussed above – exemption method, foreign tax credit method, and deduction of foreign taxes methods correlates to one of the three concepts of neutrality - Capital Import Neutrality, Capital Export Neutrality, and National Neutrality respectively.³⁵

A. Capital Import Neutrality:

Capital Import Neutrality focuses on the impact of tax on imported capital. The objective of Capital Import Neutrality is to ensure that the total tax imposed on investment returns in a given country is the same irrespective of the residence of the investor. Capital Import Neutrality therefore advocates equalizing the tax imposed on all investors, from whichever country they may be. Consequently, Capital Import Neutrality is attained when the total tax imposed on foreign investments by the investor's country of residence and the capital-importing country equals the tax imposed on domestic investments, i.e., the tax the capital importing country imposes on its residents'

³⁴ Dishat B. Mehta, “*Elimination of Double Taxation*”, International Taxation – A Compendium, The Chamber of Income Tax Consultants, fifth edition, 2005. However there are many variants of the two methods.

³⁵ Tsilly Dagan, “*National Interests In The International Tax Game*”, 18 Va. Tax Rev. 363, *367

investments at home.³⁶ Hence, universal Capital Import Neutrality could be achieved if; all countries imposed an identical rate of taxation on source principle and exempt residents from tax on their income produced abroad.

B. Capital Export Neutrality:

The primary objective of the Capital Export Neutrality policy is to prevent tax considerations from distorting investors' decisions regarding where to invest.³⁷ CEN is achieved when the total tax imposed by the country of residence and the host country combined equals the tax imposed on domestic investments in the country of residence.³⁸ In order to prevent tax considerations from distorting decisions on where to invest, Capital Export Neutrality seeks to ensure identical after-tax profits for all investors whether they invest in their country of residence or abroad, assuming identical before-tax rates of return in both countries. Such neutrality could be achieved if all countries were to tax only their residents on their worldwide income.³⁹

C. National Neutrality:

Contrary to the approach taken by Capital Export Neutrality, National Neutrality designates national, as opposed to global, prosperity as its target. Advocates of National Neutrality argue that a national government cannot be indifferent as to the question of which government gets to collect the taxes, since tax revenues collected by the home country add to the national welfare while foreign taxes do not. Thus, they believe that investors should be encouraged to invest abroad only if both the investor and the government benefit from such investment. National neutrality is attained, therefore, when the tax revenues of the country of residence as well as the after-tax returns of its

³⁶ Ibid

³⁷ See, “*The Economics of International Tax Policy: Some Old and New Approaches*”, Daniel J. Frisch, 47 Tax Notes (TA) 581 (Apr. 30, 1990).

³⁸ See “*A Note on the Optimal Taxation of International Investment Income*”, Thomas Horst, 94 Q.J. Econ. 793-94 n.3 (1980).

³⁹ Tsilly Dagan, “*National Interests In The International Tax Game*”, 18 Va. Tax Rev. 363, *368

residents are equal, whether the income is generated at home or abroad.⁴⁰

Tax Treaties

There are about 2000 bilateral tax treaties, most of which are based upon the OECD and the UN Model Tax Treaties. Most tax treaties do not impose tax; instead they limit the tax otherwise imposed by the State. The objective of the tax treaties is to facilitate cross border trade and investment by removing tax impediments to these cross border investments. One of the most important objectives of a tax treaty is to prevent double taxation and most of the provisions are directed towards it. Other objectives of tax treaties include elimination of fiscal evasion i.e. tax avoidance, exchange of information and determining dispute resolution mechanisms.⁴¹

The OECD Model Treaty eliminates or reduces double taxation by requiring the source country to concede on its tax in favour of the residence country i.e. it gives emphasis on the residence principle, and thereby it favours capital exporter countries to capital importer countries. Mostly developing countries are net capital importers and the developed countries are the net exporters. Recognising this fallacy, the UN formulated its own Model Tax Treaty which gave emphasis on the source principle and not the residence principle, thereby favouring the developing countries. The UN Model Treaty does not contain specific limitations on the withholding tax rates on dividends, interest and royalties imposed by the source country, and thus imposes fewer restrictions on the tax jurisdiction of the source country. This is the main difference between the two Model Treaties.

Tax treaties once adopted can be modified by mutual consent of the Contracting Parties. A tax treaty like other treaties under international law is governed by the Vienna Convention on the Law of Treaties. The status of the OECD Model Tax Treaty and its commentary under the Vienna

⁴⁰ Ibid

⁴¹ See Brian J. Arnold & Michael J. McIntyre, "International Tax Primer", Second edition, Kluwer Law International, The Hague, The Netherlands, 2002, p.104

Convention on Law of Treaties is unclear. However, the controversy is of little significance since both the documents have been given substantial weight by States as well as the Courts.⁴²

Emergence of E-Commerce

With the expansion of Internet and its widespread use, its commercial implications were discovered and exploited by small and large vendors alike. Commercial activities carried on over internet are referred to as 'e-commerce'. Sale of consumer goods and services, advertisements, licensing and so on is carried out on internet.

E-Commerce is not covered within the existing international tax regimes since it allows businesses to operate without creating a permanent establishment in any country. There are three reasons for the same - 1) digitized information traveling between computer terminals around the world does not constitute "fixed" presence for tax purposes. 2) Internet businesses are present both everywhere and nowhere since a web site does not contain any tangible property but is merely a combination of software and electronic data, it could not constitute a "fixed place of business" within the meaning of Article 5 of the OECD model treaty, and thus, it cannot constitute a permanent establishment. 3) Electronic commerce allows businesses to avoid permanent establishment in any state by structuring and fragmenting related physical activities--warehousing, delivering, collecting payment--so that they do not meet the threshold for being considered permanent establishment. Modern electronic communications allow for the provision of many services from a distance.⁴³

E-Commerce – 1) allows businesses to relocate their taxable activities around the world at low cost and without interruption in response to changes in legal and economic environment 2) complicates the attribution of income and expenses to a particular part of the transaction 3) clouds the distinction between providing services and transferring property 4) complicates the administration and collection of taxes.

⁴² *Ibid* at p.113-116

⁴³ Oleksandr Pastukhov, "International Taxation Of Income Derived From Electronic Commerce: Current Problems And Possible Solutions", 12 B.U. J. Sci. & Tech. L. 310, *320

In sum, electronic commerce creates opportunities and incentives for businesses to avoid taxation under the current international taxation regime.⁴⁴ Electronic commerce also makes it easy to manipulate activities of a business to minimize worldwide tax liability without incurring high costs or business interruptions. Electronic commerce affords businesses an unprecedented mobility, allowing them to easily migrate to a different jurisdiction in response to any adverse economic changes--including introduction of tax rules designed to “catch” electronic commerce activities. A company could locate its web site on a server in a “tax haven” to create a permanent establishment there, and continue to use that server to conduct business anywhere in the world. The company could also establish its formal residence in a “tax haven” and locate its production activities in jurisdictions that do not tax such activities. Even when a permanent establishment location of an Internet-based business is determined, attribution of income to the permanent establishment is extremely difficult, because it is unclear where and when the income-generating event occurs. Further, the speed with which transactions take place over the Internet sharply increases the volume of transactions, making it more burdensome to apply separate transactional transfer pricing. The Internet also complicates tax administration and collection. Traditional audit trails are not generated in most Internet transactions.

Hence the emergence of e-commerce definitely possesses some serious questions to the international tax regime, whose answer has yet to be found out.

⁴⁴ Ibid *328

Closing Note

From the above introduction to international taxation, it is clear that the regime of international taxation exists through bilateral treaties (based upon Model treaties) between the Contracting States. Though the regime is in place, persons (especially MNCs) can easily escape from payment of tax, because of the existence of tax havens and weaknesses in the transfer pricing rules. The objective of avoiding double taxation to a certain extent is solved but the problem of undertaxation or erosion of tax base still persists. Further, with the development of e-commerce, new questions have arisen, particularly as regards to the concept of permanent establishment. Hence the international tax regime has to be restructured or amended so as to respond to the current challenges and drawbacks.

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