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Taxation of Residents on Foreign Source Income

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Taxation of Residents on Foreign Source Income

Peter Harris

The prescriptive rules in tax treaties for taxation of foreign source income in the residence country are more limited than those that apply to restrict source country taxing rights. This is despite the fact that the acknowledged purposes of tax treaties (elimination of double taxation and prevention of fiscal evasion) have equal relevance for both source and residence countries. The comparative lack of prescriptive rules has an important impact on the manner in which the taxation of foreign source income is administered in residence countries, with heavy reliance on domestic tax rules.

The first matter this paper looks at is the manner in which tax treaties can impact the administration of taxation in the residence country. The primary impact is an obligation to eliminate double taxation of foreign source income of residents and a number of provisions of tax treaties may be relevant in this regard. Often less obvious is the subtle manner in which tax treaties interact with anti-abuse rules, whether the anti-abuse rules are of a specific or general nature. Having identified the relevant provisions in tax treaties and their potential scope, the paper moves to consider in turn the administrative mechanics of these two issues, elimination of double taxation with respect to and application of anti-abuse rules to foreign source income. The final heading considers the effect of deriving foreign source income on general tax administration issues, with a particular focus on collection of information, proof of foreign income and foreign tax and time limits.

1. Impact of tax treaties and elimination of double taxation

Both the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] ("UN Model Convention") and the Organization for Economic Co-operation and Development's Model Tax Convention on Income and on Capital[2] ("OECD Model Convention") recognize the dual main purposes of tax treaties as the elimination of double taxation and the

sourced in some third country. In the latter case it is referred to as "third country income". None of this discussion is intended to suggest that there is general agreement on how to locate source according to general principles, but that is not something regulated by tax treaties. It is, however, something that must be regulated by domestic law, discussed further below.

1.2 Tax treaties do not limit the scope of residence country's right to tax foreign income

While tax treaties limit source country taxing ri

dividends, interest and royalties either when paid or in other circumstances, e.g. as they accrue or deemed payments of this type. By contrast, it is generally (although not universally) accepted that these rules do limit source country taxing rights, i.e. the source country may tax only when these items are "paid".

Part of the problem is that the scope of Articles 10, 11 and 12 is not specified. If the reference to "paid" and the "payer" being a resident of a contracting state determines the scope of the provisions, then those provisions would not deal with any other amounts that may be described as dividends, interest or royalties. These other amounts would fall residually into Article 21 (other income) or, perhaps, Article 13 (capital gains). Under the OECD Model Convention, this would mean that, as a general rule, the income would be "taxable only" in the residence country. By contrast, if the income falls under Article 21 of the UN Model Convention, the source country (country in which the income "arises") is granted an unlimited right to tax.[9] In any case, the better view is that Articles 10, 11 and 12 do not limit a residence country's right to tax.

The same also seems true of other distributive rules that do not refer to a residence country's right to

few rules relating to the manner in which foreign source income should be calculated and the rate of tax that may be imposed with respect to that income. After those rules are considered, the discussion turns to the main tax treaty obligation imposed on residence countries - the obligation to eliminate double taxation.

1.3.1 Non-discrimination

The non-discrimination rules in tax treaties (Article 24) contain important (though not comprehensive) limitations on the taxing rights of contracting states. While these rules are, perhaps, primarily targeted at source countries or countries hosting foreign investment, there are cases in which they can apply to residence countries. In particular, if the resident person in question is a national of the other contracting state, the residence country cannot subject that person to more burdensome taxation than its own nationals who are also residents.[10] Similarly, a residence country cannot subject a resident entity conducting a business to more burdensome taxation by reason that the entity is owned or controlled by residents of the other contracting state.[11] While this provision has important application where income is sourced in the residence country, it can also apply to the taxation of foreign source income (including third country income) and, in particular, the application of unilateral foreign tax relief (discussed below).

By contrast, Article 24(4) prevents a residence country from denying a resident a deduction for "interest, royalties and other disbursements" paid to a resident of the other contracting state if a deduction would be available were the amount paid to a resident of the residence country. This rule is not targeted at the calculation of foreign source income, but can have application in that context. It has no application except with respect to deductibility of amounts and so does not apply to tax rates or tax reliefs such as tax credits.

While these provisions prevent discrimination in the taxation of foreign source income based on nationality, ownership, control or recipient of payment, they do not prevent discrimination in the taxation of foreign source income per se. So, for example, provided those rules are not engaged, a residence country is at liberty to impose more tax on foreign source income than on equivalent domestic source income, whether that be by reason of tax rates or the availability of deductions or reliefs. Tax treaties simply do not engage with this sort of discrimination. Similarly, tax treaties do not expressly prevent more or less taxation by a residence country of income derived by its residents

[10] Article 24(1) of both the UN and OECD Model Conventions.

[11] Article 24(5) of both the UN and OECD Model Conventions.

from some foreign countries (including tax treaty partners) when compared to income derived from other foreign countries (no most favoured nation requirement).[12]

1.3.2 Corresponding adjustments

Residence country taxation may also be affected by the obligation to make corresponding adjustments under tax treaties. This occurs where the other contracting state makes a transfer pricing adjustment (primary adjustment) in accordance with Article 9(1) (associated enterprises) or a specific allocation of profits to a permanent establishment (hereafter "PE") under Article 7(2). Articles 7(3) (OECD Model Convention only) and 9(2) may require the residence country to adjust the taxation of the associated enterprise or holder of the PE resident in that country in order to avoid double taxation.[13] Conceptually, the corresponding adjustment rules are primarily targeted at the allocation of source of income between countries. However, they are not limited in that regard and in an appropriate case can be applied to residence country taxation of foreign source income.

1.3.3 Elimination of double taxation

The primary manner in which residence country taxation of foreign source income is affected by tax treaties is the obligation to eliminate double taxation of income that has already been taxed in the source country (Article 23). There are two alternative versions of Article 23 - the exemption method (Article 23A) and the credit method (Article 23B). Details of the manner in which these provisions are to be administered in the residence country are discussed below. At this stage, it is important to identify some limitations as to the scope of the obligation in Article 23 and then the discussion moves on to consider how countries respond to those limitations.

Article 23 (whether Article 23A or 23B) obliges the residence country to eliminate double taxation of income of a resident that "in accordance with" the tax treaty "may be taxed" in the other contracting state. In this context, it is irrelevant whether the income can be correctly described as sourced in the other contracting state. The issue is simply whether according to the distributive rules of the tax treaty the other contracting state has a right to tax or not. The OECD (though not the UN)

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12 In this context, most favoured nation treatment would require the residence country to tax income derived from a particular foreign country no less favourably than income derived from any other foreign country. Alternately, national treatment in this context would require that income derived from a particular foreign country be taxed no less favourably than income derived from the residence country itself.

13 Some countries take the view that the mutual agreement procedure (discussed below at 4.3) can produce a similar result; for example, see paragraph 2 of the Commentary on Article 25 of the UN Model Convention.

confirms that whether the other contracting state has a right to tax or not is to be determined by that other contracting state applying the tax treaty to its own law.[14]

countries will also make provision for relief of economic double taxation of corporate income where a subsidiary in the other contracting state distributes a dividend to a parent corporation resident in the subject country. By contrast, it is rare (and increasingly so) for tax treaties to provide for relief from economic double taxation of corporate income derived by portfolio shareholders (e.g. individuals and non-substantial corporate shareholders) through a corporation. Any such relief for portfolio shareholders is usually provided unilaterally in the domestic law of the residence country.

As mentioned, the obligation to provide tax treaty relief for the elimination of juridical double taxation typically depends on whether the source country has a right to tax when applying the tax treaty to that country's tax law. Most commonly, treaty provisions for relief from economic double taxation (where they exist) do not follow this approach. For example, the application of such provisions is not dependent on the distribution in question falling within the definition of "dividend" in Article 10, as applied by the source country. In providing relief from economic double taxation, often there is a separate reference to "dividend" in the Article on elimination of double taxation, which does not draw its meaning from Article 10. Rather, the meaning of any reference to "dividend" in the Article on elimination of double taxation (absent any express definition) will be determined by the residence country applying the tax treaty to its own law, and Article 3(2) of the treaty may be relevant in this regard.

Another general limitation on the application of Article 23 as found in model tax treaties is that it is relatively brief and so does not elaborate on many of the details that are often necessary in applying the provision in practice. Other provisions in tax treaties that suffer from brevity are often supplemented with extensive commentary or guidelines, but that is not the case with Article 23. As a result, residence countries often need to create domestic rules (statutory or otherwise) detailing the manner in which double taxation is to be eliminated under its tax treaties.[21] For this reason, it is common for the part of the Article on the elimination of double taxation that applies to a particular contracting state to refer to the provisions of that state's domestic law that eliminate double taxation. These domestic law rules may apply only to tax treaties, but more often they form the basis of unilateral foreign tax relief granted by that country, a matter to which the discussion now turns.

1.4 Unilateral foreign tax relief

[21] See paragraphs 38 and 60 of the Commentary on Article 23 of the OECD Model Convention, reproduced in paragraph 16 of the Commentary on Article 23 of the UN Model Convention.

The vast majority of developed countries and many developing countries unilaterally in their domestic law provide relief from double taxation of foreign source income of residents. Unilateral relief often (though not always) reduces the impact and significance of the obligation to provide elimination of double taxation under tax treaties. This may happen for a number of reasons. First, as mentioned, the elimination of double taxation Article in many tax treaties refers to and is limited by the scope of the domestic law rules. Second, there are instances where the method of foreign tax

taxation of cross-border income is consistent with a global view of allocating resources efficiently. As Article 23 illustrates, the main methods for elim

rise to a full source country taxing right under Article 7).[23] The situation can also be complicated if the residence country unilaterally offers an exemption and the scope of that exemption is broader than the source country's right to tax under a tax treaty with the residence country.

As a result, some countries in their tax treaties and unilaterally require that the source country actually subject the income to tax before the residence country exemption is available.[24] While a potentially important limitation on the provision of an exemption, subject to tax clauses raise difficult administrative issues as to precisely what constitutes the source country subjecting foreign source income to tax. There may be issues as to the type of foreign tax that qualifies, whether the quantum of foreign tax is relevant and whether the taxpayer can elect to pay the tax in an effort to qualify for the exemption in the residence country.

Consistent with ensuring that income is fully taxed, the exemption method under tax treaties usually does not apply to income that may be taxed only partly by the source country. This is particularly the case where payments such as dividends, interest, royalties and even service fees may be subjected to a limited withholding tax in the source country. In these types of cases, tax treaties usually switch to the foreign tax credit method, a switch that is recognised in Article 23A(2).

Even where an exemption is available, there are numerous reasons why the residence country is likely to require the taxpayer to declare the exempt foreign income in their annual tax return. One reason is simply to check that the foreign income has been properly calculated (including the appropriate allocation of expenses) and the exemption properly claimed. If a subject to tax clause applies, the taxpayer may be required to provide proof of the payment of the foreign tax. Declaration of foreign source income may be necessary for other reasons, especially where deriving exempt foreign source income impacts on the taxation of other income or the availability of certain government benefits such as social security payments.

A number of countries adopt exemption with progression and application of this variation of the exemption method is recognized by Article 23A(3). Exemption with progression is only relevant where the taxpayer is subject to progressive tax rates. It means that exempt fo(foreign inco)3.5(me cx i

provided by domestic law of the residence country. The whole of the exempt foreign source income may take up the lower tax brackets or perhaps the proportion that the exempt foreign source income is of the taxpayer's total income.

Exempt foreign source income may also have an impact on other residence country tax attributes of the person deriving the income. The most obvious example is the use of tax losses. Most countries allow losses, especially from business activities, to reduce income from other activities or be carried forward. Where losses are available, a question is whether those losses are to be reduced by exempt foreign source income, which would mean that the losses are not available to reduce other, taxable income. This is a matter that is not regulated by treaties. As such, it is a matter for domestic law. Again, there are different styles of rule that may be applied in this regard, from no requirement to use

Box 2
Exempt Foreign Income and Domestic Losses

2.2 Credit method

The foreign tax credit method is the other main method by which residence countries eliminate double taxation of foreign source income and, as discussed with respect to the exemption method, is typically at least the residual method. This method is explicitly provided for in Article 23B of model tax treaties, although this provision is brief and does not contain many of the details required for the operation and administration of a foreign tax credit system. As discussed, these details are typically provided by domestic law, often in the context of unilateral relief. It is fair to suggest that, so far as the rules in Article 23B are concerned, those rules facilitate rather than limit the choices available to a residence country in implementing a foreign tax credit system.

The foreign tax credit system eliminates double taxation by reducing residence country tax due with respect to foreign source income by any tax imposed on that income by the source country. All foreign tax credit systems must deal with the possibility that the source country tax exceeds the residence country tax and so may give rise to what is commonly referred to as excess foreign tax credits. Virtually all foreign tax credit systems incorporate a limitation on credit, which operates so that excess foreign tax credits are non-refundable and cannot be set against tax due with respect to domestic source income (sometimes called ordinary credit). This limitation is expressly accepted in Article 23, although that provision does not contain details as to how the limitation on credit should be calculated.

Box 3
Limitation on Credit — Excess Foreign Tax Credits

A resident derives 100 foreign source income. The foreign income is taxed in the source country at the rate of 40%. The residence country eliminates double taxation in the form of a foreign tax credit. The residence country taxes at the rate of 30%.

Foreign Income	100
Source Tax @ 40%	40

Income Net of Foreign Tax	60

Under the domestic laws of a number of countries, the credit is simply limited to the amount of domestic tax due with respect to foreign source income. Such an approach does not permit excess relief. Other countries do take into account the amount by which foreign tax may exceed domestic tax, e.g. by recognizing excess foreign tax credits and permitting these to be carried forward for use in future years.

Box 4
Limitation on Credit — Country-by-Country Approach

A resident of Country B derives 100 business profits from Country A and 100 interest from Country A. The tax rate on business profits in Country A is 30% and Country A imposes a final withholding tax of 10% on interest paid to non-residents. Country B taxes the resident at 20%.

Country A Tax

Business Income	100
Source Tax @ 30%	30
Interest Income	100
Source Tax @10%	10

Income Net of Foreign Tax	160

Country B Tax

Gross-up (30 + 10)	40

Taxable Income	200
Residence Tax @ 20%	40
Less Foreign Tax Credit (limited to residence tax)	40

Net Residence Tax	0

Net Return	160

If separate calculations were required for calculation of the foreign tax credit for the business income and the interest income (i.e. an item-by-item approach) then the credit for source tax on the business profits would have been limited to 20, i.e. the residence country tax on those profits. There would have been excess foreign tax of 10 (30 - 20) for which no foreign tax credit would be available due to the limitation on credit. Further, there would have been 10 Country B tax payable with respect to the interest income because the Country B tax on this income exceeds the source tax by this amount. By using the country-by-country approach to the limitation on credit, Country B permits the excess source tax on the business profits to reduce residual Country B tax on the interest income.

Irrespective of whether excess foreign tax credits may be carried forward or back, foreign tax credit systems must incorporate rules as to the scope of calculating the limitation on credit. Article 23 permits a country to calculate the limitation on credit separately for each item of income. So, for example, foreign tax paid with respect to the profits of each PE, income from each piece of immovable property, each dividend, interest or royalty etc. would be tested against the residence country tax payable on that item of income to determine the limit of the credit available. This is often

referred to as an *item-by-item*, *source-by-source* or *slice-by-slice* approach to calculating the limitation on credit. It can result in numerous calculations by a person deriving foreign source income from a particular treaty country. It can also mean that foreign tax that exceeds residence country tax on one item of foreign source income cannot be used to reduce residence country tax that exceeds foreign tax on another item of foreign source income, depending on how excess foreign tax credits may be used.

Some countries opt to simplify the item-by-item approach by amalgamating different items of foreign source income in some fashion for purposes of reducing the number of times the limitation on credit has to be calculated. There are a number of ways to achieve this reduction, the main difference between each type being the extent of averaging of foreign tax that is permitted. One obvious choice is to calculate the limitation by reference to foreign tax payable on all income derived by a person from a particular country, i.e. a *country-by-country* limitation. This can be consistent with the bilateral nature of tax treaties, but some countries amalgamate income from numerous countries when calculating the limitation on credit. This is more likely to happen under unilateral relief.

The amalgamation may simply be all of a person's foreign source income from wherever derived. The total foreign tax paid with respecmber w178Cderived.

question is whether these lower rates apply to foreign source income of the relevant type. While tax treaties do not typically deal with such issues, Article 23 requires a foreign tax credit to be granted irrespective of the domestic tax rate on the foreign source income. Similar issues arise as to whether and in which manner particular reliefs (such as foreign source losses and allowances and tax credits available for things such as research and development) are available with respect to foreign source income.

The taxation of foreign source income by a residence country at non-uniform rates can also impact on the manner in which the limitation on credit is calculated. This is also the case where an exemption is available with respect to some types of foreign source income, but a foreign tax credit is available with respect to other types. The issues are similar to those discussed above at 2.1 in the context of exemption with progression. In the context of progressive rates, the issue is whether foreign source income, for which foreign tax credits are available occupy lower tax brackets (bottom slicing), are treated as occupying proportionately all tax brackets or are treated as income subject to highest tax rates (top-slicing). Bottom slicing increases the likelihood that the limitation on credit will be engaged.

With the exemption method, only one slicing rule is required in applying exemption with progression (see Box 1 above). If the limitation on credit under a foreign tax credit system is calculated in any manner other than a worldwide limit, then the system will require multiple slicing rules to match the number of times the limitation on credit may be cal

Further complications may be caused by the interac

foreign tax paid within a particular year. These sets of details are not covered by tax treaties and again are typically dealt with in domestic law.[25]

Finally, as with exempt foreign source income, there are issues as to how the foreign tax credit method interacts with the application of domestic loss relief. If losses (foreign or domestic) reduce foreign source income for which a foreign tax credit is available then the limitation on credit will be lower, i.e. the application of losses increases the likelihood of excess

Again, foreign tax credit countries have a number of options as to how to deal with the interaction between losses and the limitation on credit. They may force the losses to be used against foreign source income, accepting that excess foreign tax credits may be worthless or at least worth less than the losses that gave rise to them (e.g. because domestic losses are involved and they could otherwise be set against domestic source income). Alternatively, the losses may be quarantined so that they cannot be set against particular types of foreign source income for which foreign tax credits are available. Various versions of a proportionate rule may also be used. Again, a popular approach is to permit the taxpayer to choose whether the loss is used to offset foreign source income or not.

Finally, tax sparing is of particular importance for developing countries in concluding treaties with countries that adopt the foreign tax credit system. Tax sparing involves the residence country granting foreign tax credits for tax that the source country has intentionally forgone in order to attract investment. The appropriateness of tax sparing has been intensely discussed for many years and is noted in the Commentaries of the UN and OECD Model Conventions.[26] The form of tax sparing is typically unique and varies substantially from treaty to treaty (if it is available). However, a few general observations may be made.

The main difficulty for a residence country in administering tax sparing is identifying the tax forgone for which a foreign tax credit is to be granted. Almost inevitably, the tax forgone will be identified with respect to a particular type of income, e.g. income from manufacturing, agriculture, construction or even passive income such as dividends, interest and royalties. If the income identified is too general, the country granting tax sparing may have concerns if circumstances change, e.g. the economic environment changes such that the residence country's reason for granting tax sparing relief no longer exists. This has led to a practice where more recent tax sparing provisions are often more targeted. In particular, a tax sparing provision may have a sunset clause,

In all of these matters, the tax administration of the residence country has an interest in checking that tax sparing is appropriately claimed. It may require certain proof before accepting a claim for tax sparing. This may take the form of evidence that the income in question was declared in a tax return to the source country and specifically granted relief by that country. It will also be necessary to quantify specifically the amount of tax forgone and the residence country tax administration is likely to require evidence as to the manner in which the tax forgone is calculated. Some residence countries may require a certificate from the source country tax administration to support these matters. Nevertheless, a residence country may remain concerned at the possibility of relief in the source country (which is eligible for tax sparing) being manipulated and artificially claimed in circumstances where the relief is not intended to apply. In this context a residence country may incorporate anti-abuse rules into the tax sparing provision or reserve the right to apply domestic anti-abuse rules.

Once the application of tax sparing is determined and the amount of source country tax forgone is quantified, tax sparing raises few issues in addition to those generally raised by a foreign tax credit system.

2.3 Deduction of expenses

Whether a residence country adopts the exemption method or the credit method and whether it does it by tax treaty or unilaterally, it will need rules for allocating expenses between foreign and domestic source income. In the case of the exemption method, this is needed to ensure that expenses incurred with respect to exempt income do not reduce taxable income. In a foreign tax credit system, this apportionment is needed in order to appropriately apply the limitation on credit. This is particularly important where the foreign tax would otherwise exceed the domestic tax liability on the relevant foreign source income. It is common for the amount of cross-border income to be calculated

deductions claimed in the source country (e.g. under Article 7 and its Commentary),[29] they have virtually no impact on the deductibility of expenses in the residence country. In principle, it is not contrary to a tax treaty for a residence country to discriminate against residents deriving foreign source income, whether by reason of application of tax rates, denial of concessions available with respect to domestic source income or the non-deductibility of expenses.[30]

As a matter of domestic tax law, the allocation of expenses by residence countries to foreign source income is often not very detailed. In general, there are two extreme approaches that a residence country may adopt and these reflect approaches to allocation of income between countries.[31] At one extreme, a country may adopt a transactional approach and seek to determine the extent to which a particular expense is incurred in deriving the foreign source income in question. Some expenses will be difficult to attribute, such as interest on a loan

allocated to that income (e.g. cost of assets), whereas more general expenses are allocated on an apportionment basis (e.g. overheads). Generally accepted accounting practice can be particularly important in the allocation of expenses for tax

relief provided is often clawed back automatically under the foreign tax credit method in the future if the foreign activities turn profitable.[36]

Many countries permit, through one mechanism or a

discussed above with respect to each of these methods also apply in the context of providing underlying relief, e.g. allocation of expenses, forms of limitation on credit, identification of creditable foreign tax. However, underlying relief raises additional issues.[41] If its availability is limited to parent corporations, then the type and level of shareholding required must be specified. Commonly, this can be as low as 10%, but much higher shareholdings are also used. There are issues as to whether only direct shareholdings count or whether shares held through other related corporations count towards determining if the threshold is met, i.e. indirect holdings are also counted.

Whether the exemption or indirect foreign tax credit method is adopted, a system providing underlying relief must identify the type of distributions made by non-resident corporations that may qualify for the relief. Tax treaties, if they provide for underlying relief, rarely deal with this matter in any detail. Domestic tax law may be more specific as to whether only something that may be described as a "dividend" under corporate law can qualify or whether certain receipts that a domestic tax law may deem to be a dividend also qualify for underlying relief, e.g. interest paid on profit sharing debentures or convertible notes, liquidation distributions, returns of capital or the price paid on a share buy-back.

Indirect foreign tax credit systems raise additional issues. An indirect foreign tax credit system is a form of imputation system, i.e. corporation tax paid by the distributing corporation with respect to the profits distributed is imputed to the parent corporation. In addition, it raises issues of allocating and apportioning foreign tax paid with respect to corporate income to particular distributions. In particular, the distributing corporation may have paid corporation tax at various rates with respect to its profits. When it distributes only part of those profits, an indirect foreign tax credit system must determine which profits have been distributed.[42]

Different countries adopt different approaches in identifying which profits have been distributed for the purposes of an indirect foreign tax credit system. There may be an ordering rule based on when the profits were derived, e.g. first in first out. There may be an ordering rule based on the amount of corporation tax paid with respect to the profits, e.g. highest taxed profits distributed first. There may be an overall apportionment, e.g. all retained corporate profits are distributed proportionately. It is

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[41] Generally, see Harris & Oliver (2010), note 1, pp. 286-91.

[42] For a comprehensive discussion of allocation of corporate profits and corporate tax to corporate distributions and the indirect foreign tax credit system as an imputation system, see Harris (2013), note 39, pp. 298-326 and 378-9 and the references cited therein.

also possible that the distributing corporation has some discretion in identifying the profits that have been distributed. Even if there is no such discretion, without complex rules for looking through and amalgamating the identity of members of a corporate group, some discretion can often be obtained through strategic distributions within a corporate group, i.e. through the use of mixer corporations.[43]

If tax treaties deal with underlying foreign tax relief for foreign source dividends, the provisions are usually limited to direct investors.[44] However, there is an increasing trend, particularly in European countries, to grant more arbitrary forms of dividend relief to non-corporate shareholders generally and extend this relief to foreign dividends. The relief often takes the form of a limited dividend exemption or, more commonly, a lower tax rate applied to dividends.[45]

3. Administering anti-avoidance rules

As noted above, tax treaties have two primary purposes - elimination of double taxation (heading 2) and the prevention of fiscal evasion. The latter topic is considered specifically in a separate paper,[46] but it is useful to make a few comments at this stage in the specific context of residence country taxation of foreign source income. As discussed, much of that taxation is not regulated by tax treaties directly. Nevertheless, residence country taxation of foreign source income is just as prone to tax planning, tax avoidance and tax evasion as the taxation of domestic source income. There are two aspects to this. The first is whether anti-abuse rules that apply generally also apply to the taxation of foreign source income. The second is whether the nature of foreign source income and associated relief from double taxation are prone to particular types of tax avoidance.

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[43] A mixer corporation is a non-resident holding corporation that is used to receive income taxed at various rates from related foreign corporations in order to mix the income so that it is on average taxed at a rate approximating the corporate tax rate in the residence (parent) country. In this way, when the mixer corporation distributes to the parent corporation, the parent corporation is entitled to a foreign tax credit that exhausts any residence country tax liability. The effect is to minimize the impact of the residence country's limitation on credit. Generally regarding mixer corporations and underlying foreign tax credits, see Harris & Oliver (2010), note 1, pp. 290-1 and 407-410.

[44] During the 1970s to 1990s there was a tax treaty practice by some European countries to grant dividend tax credits available to resident shareholders to treaty partner shareholders, especially portfolio shareholders. This involved relief from source country tax. Residence countries reciprocated by, in effect, granting direct foreign tax credits to the shareholder for tax that had only been paid at the corporate level in the source country. Most of these treaties have now been replaced or amended to remove this provision. See Harris (2013), note 39, pp. 351-4.

3.1 Application of domestic rules

where the taxpayer may elect to be taxed in the source country (and does so) so as to meet a subject to tax requirement for claiming an exemption in the residence country.

The foreign tax credit method can also be abused. The use of mixer corporations to avoid limitation on credit rules was mentioned above. Source countries have sometimes participated in the manipulation such as where they grant designer tax rates so as to maximize relief in the residence country. Scope of the relief may also be abused, such as where the residence country provides underlying foreign tax credits for a payment that is deductible in the source country. Here the potential for abuse may not be as great as under exemption method, but residence country tax savings may still be pursued.[50]

Historically, the biggest problem for residence country taxation of foreign source income has been deferral of that taxation by retaining the income in a foreign corporate tax shelter. As corporations are separate legal entities and typically separate taxpayers, the controllers of a corporation (often high-wealth, high-tax rate individuals) can cause the corporation to retain profits in order to avoid the higher tax rates of their shareholders. This can happen in a pur

Some countries' anti-abuse rules go further and apply to income derived through foreign corporations that are not controlled by residents. Here the target is to prevent the benefits available through the foreign corporation deferring repatriation to the residence country and so taxation of foreign dividends. Most commonly, such rules are only targeted at the deferral of tax on foreign dividends. However, some countries have introduced a general rule deeming income from shares that applies on a non-discriminatory basis. Again, these types of details are not addressed in tax treaties.

These anti-deferral rules have historically been targeted at all resident shareholders in foreign corporations, whether corporate or non-corporate. Globalization is now a substantial challenge to the application of anti-deferral rules as taxpayers are increasingly willing to move their country of residence in order to avoid them. This challenge is particularly dramatic in the case of corporate shareholders. For many years, the largest group of targeted shareholders subject to anti-deferral rules has been corporate shareholders, particularly parent corporations of controlled foreign subsidiaries. The rationale for taxing such corporations immediately on the profits of their subsidiaries was in order to prevent the avoidance of residence country taxation.

However, at a conceptual level, the taxation of corporations is a method of taxation at source, particularly the taxation of the corporation's shareholders. From this perspective, the application of controlled foreign corporation rules to parent corporations is a method of preventing deferral of residence country taxation by the parent corporation's shareholders. Increasingly, resident corporations are not owned solely by resident shareholders, at least not taxable ones. Indeed, there are many corporations, particularly widely held corporations, which are majority owned by tax exempt institutions (such as pension funds) and non-resident persons (including sovereign wealth funds).

In a globalising world with increasing fragmentation of shareholders, there is evidence that the application of controlled foreign corporation rules is having an increasing effect on the location of the parent corporation's residence. Application of controlled foreign corporation rules by residence countries makes less sense if a parent corporation's shareholders are not subject to residence country taxation in the same jurisdiction as the parent corporation. In the future, residence countries that wish to address the deferral issue may find that they need to target their anti-deferral rules more precisely at the persons (often high wealth resident individuals) that are subject to residence country taxation.

4. General issues in administering the taxation of foreign source income[53]

There are four core areas of tax administration - collection of information, assessment, dispute

In addition, further information will be required because of the nature of the income as foreign source income and the impact of the treaty provisions discussed above. In particular, most residence countries treat foreign source income differently depending on the country from which the income is derived, and this is particularly a consequence of the bilateral nature of tax treaties. So it will be necessary for a taxpayer to declare th

require information as to the amount of foreign tax imposed on particular items of foreign source income. For reasons described in the last two paragraphs, the allocation of particular foreign tax to particular foreign source income could in some cases be complex. In the case of unilateral relief, source country tax will have been imposed with respect to the source country's classification of income. This source country tax must be reallocated to income as classified by the residence country. This will happen if the schedular or global income calculation system in the source country is not the same as that in the residence country.

The application of tax treaties can make this conversion process more complex for foreign tax credit countries than in the case of unilateral relief. This is because the tax imposed by the source country has to be allocated to income as classified under particular provisions of a tax treaty. The residence country must then reallocate that tax as allocated to income as classified under the tax treaty to its own domestic classification of income. There cannot be hard and fast rules in this regard and each foreign tax credit country is likely to adapt a system to its own circumstances. However, in perhaps the vast majority of cases faced by a residence country tax administration the reallocation process will be straightforward.

4.1.2 Forced disclosure

As a resident taxpayer is within the jurisdiction of the residence country tax administration, there are no legal restrains on requiring the resident taxpayer to declare foreign source income (as discussed above at 4.1.1) to the tax administration and demanding that the return be supported with relevant documentation. Failure by the resident taxpayer to declare required information will be met with a penalty under the domestic law of the residence country. As a general rule, most countries collect such penalties in the same manner as taxes, and in this regard the discussion below at 4.4 is relevant. However, a tax administration will not know whether to impose such a penalty unless it can independently verify that the requirements as to declaration of foreign source income have not been met. This is the power of audit which requires the use of entry, access and forced information gathering powers. The procedure for auditing with respect to foreign source income usually follows the same procedure and time limits as for domestic source income.

The use of forced information gathering powers by a residence country tax administration with respect to foreign source income raises serious jurisdictional issues. This is especially the case if the relevant information is beyond the physical jurisdiction of the residence country. The legal power of tax administrations to access premises, documents and other information is most always

jurisdictionally unlimited. That is, a tax administration will have a right according its own country's law to access information wherever it is located, including in a foreign country. However, in the absence of agreement with a foreign country (e.g. through treaty) the tax administration of a particular country is likely to breach the law of the foreign country (either its general criminal law or a specific law such as with respect to confidentiality) if it tries to exercise its information gathering power there. Further, tax administrations often have strict limits on their right to delegate administrative powers to other institutions, whether the delegation is to a local institution or a foreign institution such as a foreign tax administration. So in the absence of an express power, a particular tax administration may not even be able to request that a foreign tax administration provide assistance in collection of information.

Even if a particular tax administration has domestic power to request assistance from a foreign tax administration in the forced collection of information, it is unlikely that (in the absence of a treaty) the foreign tax administration could comply with the request. This is because the foreign tax administration will have been established for the purposes of administering local taxes (not foreign taxes) and its powers, including its information gathering powers, will have been granted exclusively for that purpose. This means that in almost all cases the foreign tax administration will (without more) have no domestic legal power to collect information for the enforcement of foreign tax laws.

Therefore, when it comes to enforcing residence country tax consequences of a resident taxpayer deriving foreign source income, lifting these limitations on exchange of information with the source country tax administration is critical. The potential for this exchange and easing these limitations is facilitated by tax treaties and, in particular, Article 26. Article 26(1) permits the competent authorities of the treaty partners (typically the tax administrations) to exchange information "as is foreseeably relevant for carrying out the provisions" of the treaty. It also permits exchange for the "administration or enforcement of domestic laws concerning taxes of every kind and description", whether imposed by the treaty partners, their political subdivisions or local authorities. Accordingly,

Exchange of information typically takes one of three different forms.[56] It may be provided to comply with a request of the competent authority of the treaty partner. Some information may be provided automatically and this is particularly the case with computer-generated records. Thirdly, the competent authority may provide information of its own initiative, i.e. spontaneously, such as where it feels that the competent authority of the treaty partner may view the information as relevant. Automatic exchange of information is particularly topical, especially in the context of residence country taxation of foreign source income.

4.2 Assessment

Based on the information collected, a tax law will provide for the making of an assessment or tax decision. These decisions are of two types, either self-assessment by the taxpayer or an administrative assessment, including an amendment of a self-assessment. The procedure for assessment of tax with respect to foreign source income usually follows the same procedure and time limits as for domestic source income. In particular, foreign source income of residents is commonly subject to tax by way of self assessment including not only the assessment of the primary tax liability but self assessment of the right to elimination of double taxation whether by exemption or foreign tax credit. Tax treaties do not usually affect the application of domestic assessment rules although there is a special rule in Article 25(2) that seeks to extend the assessment procedure where the mutual assistance procedure of the treaty is engaged.

One special issue regarding assessment of tax on foreign source income is the time at which elimination of double taxation becomes available in the residence country. This is particularly important where the foreign tax credit system is adopted, but can also be relevant for an exemption system, e.g. where the exemption with progression approach applies. Residence countries commonly require direct evidence that foreign tax has been paid and the assessment upon which it is based. Typically, no foreign tax credit is available until the foreign tax is paid. It is then a question of operation of the foreign tax credit system as to whether the credit is available for the tax year in which the foreign tax is paid, or whether it is available when the income subject to the foreign tax falls into charge, usually the latter.

4.3 Dispute resolution

Once an assessment or tax decision is set or accepted by the tax administration, there is scope for dispute with the taxpayer regarding, amongst others, the quantum of the assessment. Tax laws typically provide two mechanisms for resolving for reso -20.on e tae an8m9n e tace an aw. Itsment. Tax l

country's perspective, the usual objection and court review procedures will apply to an assessment of foreign source income of a resident. The same is likely to be true of a source country assessment of, in its view, domestic source income of the non-resident. These procedures of the source and residence countries are independent of each other and won't necessarily resolve issues of double taxation (or double non-taxation). However, tax treaties provide potential for unified or coordinated administrative review in an international setting. The primary benefit of such a review is that, as it involves the authorities of both countries concerned, the taxpayer may be provided with a holistic solution to double taxation.

Article 25 provides for coordinated review by the competent authorities of the contracting states of taxation covered by a tax treaty (the "mutual agreement procedure"). This procedure may be viewed as a logical extension in a bilateral setting of the typical internal review (objection) procedure

competent authority within three years of first notification of the taxation, and the UN Model Convention makes provision for the development of others.[63]

A legal difficulty with any mutual agreement between competent authorities is whether there is an internal law bar to the effectiveness of the agreement. For example, domestic law time limits may prevent a tax assessment being amended in favour of the taxpayer. Article 25(2) seeks to overcome this difficulty by prescribing that any agreement reached is to be implemented despite any domestic law time limits. Another difficulty is the interrelationship between any mutual agreement and court decisions. Some countries have an internal law provision that gives effect to a mutual agreement even if it is contrary to a court decision, but in others, the internal law does not permit the mutual

procedure. If source country taxation is reduced as a result of that procedure, this will have an impact on the manner in which the residence country calculates the foreign tax credit.

A similar example is where a resident corporation has a subsidiary in the source/host country and the source country makes a primary transfer pricing adjustment under Article 9(1). The corresponding adjustment (see above at 1.3.2) required of the residence country under Article 9(2) is a common subject of the mutual agreement procedure. Another common subject for mutual agreement is determination of the appropriate article under which a source country can tax. As source country taxing rights vary depending on which article of a tax treaty is applicable, this will also impact on a residence country's obligation to eliminate double taxation.

A major issue with the mutual agreement procedure has been the lack of a requirement for the competent authorities to reach agreement. In recent years, this has been addressed in Model Conventions through the inclusion of an arbitration procedure.[66] The UN version is triggered where the competent authorities fail to reach an agreement within three years after the presentation of the case by one competent authority to the other. This is not an independent review of the taxpayer's issues, but merely an extension of the mutual agreement procedure. The taxpayer has no express right to participate in this arbitration and in the UN version the arbitration can only be instigated by one of the competent authorities. There is no requirement that the arbitrators be independent; they may well be tax officials of the competent authorities. The taxpayer is not bound by an arbitrator's decision.[67]

4.4 Collection of tax

Finally, at least when the assessment or tax decision is not disputed (or not capable of dispute), there is the issue of collecting tax or enforcing the decision. Here again there is usually two mechanisms. There is collection directly from the taxpayer and the taxpayer's assets. Secondly, the tax laws of most countries also provide for situations in which recovery may be from a third party, e.g. a person owing money to the taxpayer such as a bank. Like other powers of the tax administration, the power to collect taxes and the mechanisms that may be used are a matter of domestic law.

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[66] Article 25B(5) of the UN Model Convention and Article 25(5) of the OECD Model Convention. Alternative A of Article 25 of the UN Model Convention does not contain an arbitration provision.

[67] See paragraph 76 of the Commentary on Article 25 of the OECD Model Convention, reproduced in paragraph 18 of the Commentary on Article 25 of the UN Model Convention.

In the context of foreign source income of residents, often the residence country has the taxpayer and local assets physically within its jurisdiction for purposes of enforcing a tax assessment. However, there will be cases where a resident person has few assets in the jurisdiction and the person is not physically available for enforcement, e.g. in cases of artificial entities or where an individual has taken flight. Here the general position is the same as discussed above at 4.1 in the context of collection of information - irrespective of what the domestic law of the residence country provides, its tax administration will not be able to collect its taxes in a foreign country. Further, in the absence of legislative authority, most tax administrations are not empowered to collect the taxes of a foreign country requesting assistance.

Article 27 of both the UN and OECD Model Conventions provides for mutual assistance of competent authorities in the collection of taxes.

The OECD/Council of Europe sponsored 1988 Convention on Mutual Administrative Assistance in Tax Matters was discussed above at 4.1.2 in the context of exchange of information. This Convention also includes provisions on assistance in recovery of taxes (Articles 11 to 16), which were influential in the drafting of Article 27 of both the UN and the OECD Model Conventions. Again, an advantage of this Convention is that it provides a multilateral solution to cross-border tax administration issues including assistance in collection of taxes.