Ectopia

- The Fundamental Problem in the Allocation of Profits under Source and Residence Rules in Model Tax Treaties
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Object of tax treaties

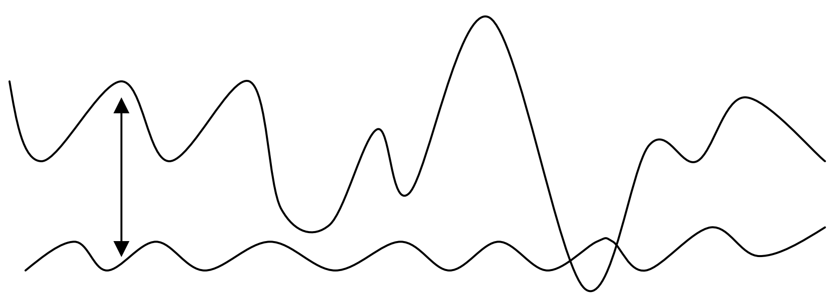
- Minimise double taxation
- Share tax between countries of source and of residence
- Why is the result crude and unprincipled?
- Subset of the question:
- Why is tax law complex and increasingly so?
- Why so resistant to reform?

Depends on a concept of income

- Indefinable; abstract
- Contrast, eg, “assault”
- Target: business or economic income
- Defined only in legal terms

Ectopia of income tax law

- Ectopia
- Gap or mislocation between
- Economic income/taxable income
- Particular problems
- Time
- Space



Time

- Problem of capital & revenue
- Essential in an annual tax system
- But irrational economically

Space

- Problem of source
- Geographical limits on taxing power

Defining source

- Taxable income: abstract metaphysical concept
- Legal simulacrum of income, not economic fact of income
- Geographical jurisdictions: precise physical phenomena
- Consider: source of the Indus River: Tibet
- Compare: source of patriotism
- Judges: “a hard, practical matter of fact”

International trade

- Jurisdictional boundaries at best an irrelevancy
- Source of profits of export-import transaction?

Solution: fictions

- Fitting metaphysical fact into physical place
- Logical impossibility
- Arbitrary rules: place of contracting, place of security
- Reality: a fiction
- Tax base: not business profits
- But legal simulacrum

Exacerbation: formality of income tax law

- Recognises separate corporate personality
- Result: at will, taxpayer can insert company
- Change
- Residence, and thus
- Source of income

Residence of companies

- Entity itself a fiction
- Residence conceptually equivocal
- Arbitrary: place of incorporation
- Or metaphorical
- “Real business carried on”

Conceptual impossibilities

- Attribute real residence to a fiction
- Assume fiction derives income
- Attribute geographical source to income

Result: familiar problems of international taxation

- Double or triple taxation
- Inappropriate taxation
- Non taxation
- Supply train inefficiencies
- Barriers to market entry
- Distortions to competition
- High compliance costs
- Non-compliance
- Difficulties of administration
- General uncertainty

Paradigm of international tax problems addressed by treaties

- *Residence country*
- Source of exports, of capital, residence of consultants
- *Source country*
- Purchaser of exports
- Borrower of capital
- Purchaser of intellectual property and services

Paradigm assumes independent parties

- In fact, often parent and subsidiary
- Pricing within group unimportant except for tax reasons
- Possibly: new entity inserted
- In effect: changes residence or source
- How to share tax between jurisdictions?
- Nominal profit and source are creatures of law, not of reality

Two models of treaty

- OECD
- United Nations
- Developed and developing countries
- Capital exporting/importing
- Both models formalistic
- Neither addresses underlying economic reality

Structure of tax treaties limits pro-capital importer benefits

- All models basically similar
- All recognise separate corporate personality
- Example: Article 5(8), OECD & UN
- Control by foreign entity
- Does not make subsidiary a pe
- International commerce can change tax position at will

Policy for sharing tax?

- No a priori principles
- Blunt proxies. Example:
- Flat rate withholding taxes on passive income
- Simply impossible to calculate correct rate
- One of many proxies for reality of tax base

How is sharing arranged?

- Based on negotiation
- Treaty model helps

Conclusion: electronic commerce

- Same problems: more acute
- Abstract, non-geographical quality of income

The game Second Life

- Virtual society
- Created by Linden Lab
- Anshechung: land agent/property developer
- Deals in Linden dollars
- Sells in real world: $US100,000 in 2005

Business taxation

- Article 7
- “Enterprise of a contracting state”
- “Permanent establishment”
- “Head office”: enterprise in home state
- Applies only to same company
- Or individual/partnership
- Mitigate by force of attraction principle

Permanent establishment in source country

- Tax only profits attributable to permanent establishment
- Profits which enterprise
- Might be expected to make
- As if distinct and separate enterprise

Force of attraction

- Added in UN model
- Other business within source state
- Sales of merchandise, other business activities
- Of same or similar kind
- As through permanent establishment

Example

- Computer warehouse & sales
- Salesmen for big contracts
- Sent by head office

Limited-time establishments

- Building site, assembly, supervisory
- OECD: 12 months
- UN: 6 months

Consultancy or services with no physical establishment

- At least 6 months within 12
- On same project or a connected one
- Eg, foreign counsel on a long case

Establishments for preparatory or auxiliary activities

- Goods for storage or display or delivery
- Purchasing offices
- Goods for processing by someone else

Agency

- Authority to conclude contracts
- Habitually does so
- Unless preparatory
- UN in addition
- Agent maintains stock, regularly delivers

Brokers & other independent agents

- Ordinary course of business
- Not permanent establishment
- UN exception
- Broker almost wholly devoted
- Relations differ from ordinary
- Commercial or financial arrangements

UN: insurance enterprise

- Has permanent establishment if
- Collects premiums or insures risks
- Unless through agent of independent status

Deduction for expenses

- Allowed
- Executive and general administrative expenses
- Incurred in source state or elsewhere

Disallowed in UN model

- Share of head office costs
- (Except reimbursement of actual costs: allowed)
- Royalties & fees
- For patents or other rights
- Commission for services or management
- Eg, sharing for knowhow

Interest on loans from head office

- Disallowed in UN model
- Except for banks
- OECD model and interest
- [To be developed]

Profits from “mere purchase” of merchandise

- Eg, agricultural products trading organization
- OECD: not taxable at source
- UN model: issue unresolved

Shipping

- International or inland
- Taxable only in place of effective management
- UN alternative rule
- Shipping operation in source state
- “More than casual”
- Unusual because of cabotage
- New Zealand open coast policy

Passive income

- Dividends, interest, royalties
- Treaties' object:
- Share taxing power between jurisdictions

Rates

- OECD specifies rates
- Dividends
- 5% if beneficial owner is company >25% of payer company
- 15% other cases
- Interest: 10%
- Royalties: no tax at source

United Nations: passive income

- Percentages not specified
- For dividends
- Participation threshold 10%

Shift to capital importing country?

- Apparently favourable idea
- May not work
- Especially for investment capital
- Capital exporter may gross up

Interest includes source-country tax

- Effect: increase cost of capital locally
- Government response
- No or low tax on outward-flowing interest