News Analysis: Revenge of the Source Countries, Part III: Source as Fiction

by Lee Sheppard

In news analysis, Lee A. Sheppard discusses the growing divergence between residence-based tax systems, advocated by industrialized countries, and source-based systems, which may better serve the interests of developing nations.

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Brazil versus Argentina.

The ideal World Cup final, right? The two best teams in the world -- it's logical. You ain't gonna see it. Actually, you could have seen it last summer in the South American Confederations Cup, in which Brazil stuffed a shellshocked Argentina 4-1. But you're not going to see it in Germany next year, not if FIFA has anything to say about it.

Why? Because FIFA is European, so there has to be a European team in the final. The Europeans are clinging to the belief that South Americans didn't really reinvent football -- it's just a matter of different styles. Meanwhile, the leading European clubs are so loaded with South Americans that Spanish or Portuguese is the lingua franca of many of them. (A world club competition might be a better idea, but the concept for the World Cup grew out of the nationalistic Olympic model.)

As this article is being written, European teams have hacked their way through a dismal round of qualification for their overrepresentation in the World Cup. So far, the qualifying matches have not revealed any brilliance. European qualifying groups are seeded so that the historically big teams -- England, Italy, France, Spain -- should easily win them and qualify automatically. Even failure to win brings a second chance through playoffs and spots for the two best second-place finishers. And let's face it -- a team that can't beat Northern Ireland or San Marino doesn't belong in the finals.

Italy did the minimum to qualify, and supporters must now hope that manager Marcello Lippi will get over his disturbing attachment to aging has-beens Christian Vieri and Alessandro del Piero. England squeaked through, with the Czechs having done them a favor by losing to the Dutch. This didn't stop the England manager Sven Goran Eriksson from telling the foaming local press that England could win the World Cup. Eriksson's plan to turn England into Juventus may be stalling, but if England hadn't qualified, he would have been fired and replaced with an English club manager who would have dug the hole deeper.

UEFA requires teams from countries that are too small to clear their own banking transactions to play off against each other to compete in the Champions League club competition. FIFA doesn't do that. Tiny countries go right into the qualifying groups, which has about the same effect as match fixing for the seeded teams.

This comes in handy when the seeded teams are underperforming. So in the final qualifying match, lazy Spain put six goals past San Marino, a tiny landlocked country in Italy whose only professional player plays in Serie C. San Marino's presence in the group enabled Spain to raise its scoring average from one to two goals per game -- that is, making up for all the goals it failed to score in previous qualifiers. Spain will nonetheless have to go to the playoffs, along with the Czech Republic.

Les Bleus, who have been redubbed *Les Anciens*, qualified automatically after they beat Cyprus with four goals. Zinedine Zidane's goal was an inspiring reminder of his greatness. It seemed like an exhibition match except for the fact that Djibril Cisse, who rescued France's game against Switzerland, failed to score in numerous chances. The French were helped along by Ireland, which held Switzerland to a draw, sending the latter to the playoffs. The playoffs will also be seeded, meaning that Spain, the Czech Republic, and Turkey will probably survive.

Well, gee, aren't the South Americans proportionally overrepresented, with 5 of the 10 countries going to the finals, as a practical matter? More than that are good enough to compete. The same holds for CONCACAF, where at most 4 of 12 teams go to the finals. Only 5 teams qualify from Africa, from which 42 teams compete for places. That's 14 teams from 64 countries on three continents, compared to 14 from Europe alone (including host country Germany) despite 13 fewer countries competing for places.

As the discussions at the September 12-16 International Fiscal Association World Congress in Buenos Aires revealed, Europe and the United States have stacked the accepted rules of international taxation in their favor the same way that FIFA has rigged the rules of World Cup qualification. "Fiscal imperialism," some of the South American hosts hissed at their smug developed-country guests. The OECD model treaty, the chief instrument of this policy, grants superior taxing rights to capital exporting countries, redistributing homeward the tax base of the countries that host their investors. The latter don't wanna take it anymore.

Ectopia

Enter the academics. John Prebble of Victoria University is from New Zealand, where they sometimes see things more clearly than Europeans and have creative ideas about taxation. New Zealand, which excels at rugby, won't be going to the World Cup finals, FIFA being rather stingy with places for the 12-country Oceania region.

Prebble told his IFA audience that taxation is a lot of fiction, and the sooner this situation was recognized, the easier it would be to get on with decisionmaking. That'd be decisionmaking, as opposed to arguing about whether a particular set of facts fits a particular fiction. It's an academic version of the old hippie adage "the truth will set you free," only using multisyllabic words. (Prebble, "Ectopia, Tax Law and International Taxation," 1997 *British Tax Rev*. No. 5, p. 383.)

Among those words is ectopia, a word Prebble uses in writing but did not use at the conference, where Spanish and English speakers struggled to understand each other. Ectopia means displacement or dislocation -- an ectopic pregnancy is a pregnancy in the wrong place. Prebble uses ectopia to describe the failure of the income tax to tax transactions according to their economic effects, instead treating them according to their legal effects, which may be wildly divergent from their economic effects. Our readers call this tax practice. Prebble thinks this divergence is killing the income tax.

"We can't draw transcendental conclusions," he told his IFA audience. "We assume that we can attribute a geographic source to any item of income." This is wrong, he explained, especially in the case of business income. "How can a mathematical difference exist as a physical fact?" Prebble asked rhetorically. If the business is multinational, source is also difficult to assign because a fraction of its income comes from each of its operations, its head office, its marketing department, its treasury operation, or its other profits centers.

Therefore, we have to recognize that source is a fiction, Prebble maintained. A corporation is also a fiction, so that a fictional person earning income that has been arbitrarily assigned to a geographic location is "one metaphor piled atop another," in his view. (Prebble, "Should Tax Legislation Be Written From a Principles and Purpose Point of View or a Precise and Detailed Point of View?" 1998 *British Tax Rev*. No. 2, p. 112.)

Prebble was appearing on a panel debating the relative merits of the credit method and the exemption method of relieving double taxation. American Stephen Shay of Ropes & Gray later agreed that source rules are necessarily artificial, so that policymakers should look at the purpose of the rule in question before assigning source to items. That is, countries using an exemption system should try not to assign a foreign source to an item of income that has not been taxed. If the item must be assigned a foreign source, these countries should impose controlled foreign corporation rules and a high-tax kickout rule.

Guglielmo Frasoni of Studio Russo Frasoni agreed with Prebble that source is "a pure convention" and that some of the old ways of designating source are obsolete. He noted that even though the exemption method doesn't ask questions about whether a particular item was taxed by the source country, exemption-method countries are nonetheless putting this requirement in treaties as a condition of exemption. These countries recognize that exemption is an incentive to foreign investment.

Shay, who was running the panel, defended residence-based taxation on the grounds that it can be perfected, as he has argued many times in these pages. He would restrict deferral, institute better rules for source and expense allocation, and impose a per-country limit on the foreign tax credit. For Shay, deferral is a larger problem than arbitrary assignment of source. (See *Tax Notes Int'l*, Sept. 29, 2003, p. 1177, and *Tax Notes Int'l*, Jan. 31, 2000, p. 547.)

Recognizing a defense of residence-based taxation, Angel Schindel of Schindel Tax Consultants objected that corporate residence, like source, is also a fiction. His fellow Argentine, Antonio Figueroa, added that source countries have jurisdiction over the income item, regardless of the residence of the earner, and that only a handful of rich countries use the residence-based OECD model treaty. Developing countries, he maintained, have been persuaded to sign OECD model-based treaties under the mistaken impression that they would encourage capital flows.

Shay explained that foreign investors from credit-method countries investing outside are treated better than local investors in those countries. Even though the American method of deferral with a foreign tax credit is supposed to be neutral as to investment choices, it encourages foreign investment because deferral tends to be perpetual. That is, this combination can be equivalent to exemption or even better than exemption. (*2005 WTD 93-19* or *Doc 2005-10372* [**PDF**].)

Matthias Werra, a senior vice president of BASF AG, argued that Germany's exemption method was more neutral as to investment choices. Frasoni argued that investors abroad should be limited to a foreign tax deduction, since both the credit and exemption methods unfairly subsidize foreign investment.

The chief virtue of the exemption method, Shay explained, is its apparent simplicity. The simplicity is more apparent than real because the exemption-method country would want to make sure that the income it exempted was taxed somewhere, meaning it would need a CFC regime. Expense allocation would also be a source of complexity in both exemption-and credit-method regimes.

Werra discussed the expense allocation problem. Certainly permitting subsidiaries and permanent establishments to deduct administrative costs avoids double taxation. He worried that the ultimate aim of the OECD project on attribution of profits to PEs might be to push deduction of administrative expenses back to the country of the parent on the grounds that they are headquarters expenses for stewardship. The result might be that those costs are not deductible anywhere. Prebble argued there is no difference between a PE and a subsidiary, so they should not be treated differently. (For discussion of the OECD PE profits attribution project, see *Tax Notes Int'l*, Mar. 28, 2005, p. 1127.)

Frasoni commented that source rules can cause double nontaxation when the two countries disagree about the source of an item, and one of them gives unilateral double tax relief. His view was that the credit method of double tax relief is less susceptible to double nontaxation than the exemption method. Well, what if the source of an item is defined in a bilateral treaty? Again, Frasoni saw more risk of double nontaxation under an exemption method, but little risk of actual double taxation. If the treaty does not define the source of an item, then the chances of double nontaxation would be roughly equal under both methods.

Well, gee, recognizing that some countries are going to insist on the credit method, what can be done to improve it? "One foreign tax is as bad as any other," Prebble mused, arguing for unlimited cross-crediting while acknowledging that excess credits can distort taxpayers' investment choices. Yoshiyasu Okada of Japan's PricewaterhouseCoopers affiliate noted that Britain has a narrow and complicated per-item limit on its foreign tax credit. He believes a per-country limit would work better. Japan, for its part, has unlimited cross-crediting, which favors foreign investment. Frasoni favored a per-item limit over a per-country limit on the grounds that it is more equitable.

New Zealand has been creative in this regard. To prevent what Prebble called the "re-sourcing" of income to tax havens, New Zealand instituted a cumulative branch equivalent account to determine the tax credit on repatriated foreign income. (For American readers, this would be like the accounts that S corporations used to be required to maintain.) Werra slagged the New Zealand approach as nothing more than a jurisdictional grab that goes beyond tax havens. "I'm deeply concerned," he said, wondering aloud whether everyone in New Zealand was not a tax compliance officer, making sure that nothing goes untaxed. Other countries, he argued, should complain about New Zealand's lack of respect for their systems.

The Great Debate

At its opening session, IFA tried a novel approach to get participants to pay attention by having them vote, electronically, on propositions that would reverse the normal practices of international taxation, which favor residence-based taxation over source taxation. So, to the extent participants were practitioners from developed countries, they were being asked to vote against the economic interests of their multinational clients. A surprising proportion of them did just that.

Schindel, who wrote the general report for the session, argued that residence taxation is a concept in crisis and that the permanent establishment/physical presence concept is obsolete. "We need radical change, not immobilism," he said. In the general report, he denounced the endless tinkering with the OECD model, while ensuring that the basic framework stays intact, as "*gatopardismo.*" The reference is to the Giuseppe de Lampedusa novel *The Leopard*, in which a Sicilian prince tries to resist Italy becoming a unified republic.

The coauthor of the IFA general report, Adolfo Atchabahian of Estudio Atchabahian, pronounced the PE concept to be "in crisis," as shown by the OECD's decision to ratchet down the period for which a construction site cannot be a PE from one year to six months. Despite this act of desperation, the concept of PE is not going to be saved by temporal notions, in his view. The PE is enjoying the protections of the host country, no matter what, and taking advantage of the local market. It is unreasonable, therefore, for its owners to expect to pay no tax to the host country, and electronic commerce is exacerbating the problem, according to Atchabahian.

Participants were asked, in a convoluted way, whether they thought a taxpayer's activity in a country should have to rise to the level of PE for it to be subject to taxation there. Fifty-five percent said it should; their arguments are what interest us here. Well, gee, wouldn't source taxation enhance equity? Fifty-one percent said no to that. Figueroa complained that these informal surveys don't accomplish much.

Reuven Avi-Yonah of the University of Michigan Law School and Dale Pinto of Curtin University in Australia argued that the PE concept is obsolete because of its reliance on physical presence. The pair suggested that economic activity in the source country provide the nexus for taxation. Source countries, Pinto noted, provide the profits, as the business benefits from the legal system, economic climate, and infrastructure even when there is no PE. This view that companies should pay for government benefits was seconded by Ian Roxan of the London School of Economics, who added that social and indirect benefits should also be added to the mix.

"You don't need any human or physical presence to make money," Pinto said. He would excuse from tax only businesses whose gross sales in the source country fell below a stated numerical level, as is done for VAT. He has previously argued that rather than protecting the source country's tax base, the PE concept has become an instrument for businesses to avoid source-country taxation.

Pinto and others have advanced the idea of a "virtual PE" that results from doing business in the source country. A virtual PE would exist when there is a continuous, significant stream of operations, that is, when regularly conducted business is going on. Pinto would then require tax to be withheld at a low rate on base-eroding payments in the form of interest, royalties, payments for services, and the like. As an alternative to arguing about whether there is business activity, Pinto suggests withholding at a low rate on total gross sales exceeding a de minimis amount, with the taxpayer invited to file a return to be taxed on a net basis. (Pinto, *E-Commerce and Source-Based Income Taxation* (IBFD 2003).)

Participants were asked whether source taxation, combined with an exemption method of double tax relief, would be more economically efficient than residence-based taxation with a credit method of double tax relief. Turns out the IFA crowd weren't students of economic efficiency: 60 percent said no.

Roxan argued that this setup would make tax decisions clearer for investors in that rate competition would be open. It would replace the reigning theory of capital export neutrality with capital import neutrality, he explained. Capital export neutrality treats all of an investor's income the same, regardless of source, while capital import neutrality treats all investors the same regardless of residence. As currently practiced by developed countries, capital export neutrality is denounced as "fiscal imperialism" in some quarters, since it is thought to discriminate against developing countries with lower tax rates. Foreign tax credits tend to neutralize the effect of lower rates.

Avi-Yonah found himself arguing against the exemption method on the grounds that it put more pressure on the source definition. The stakes would be higher because there would be no tax on foreign income. This pressure could lead to disputes about the source of income, particularly passive items. Harmful tax competition would be exacerbated, even among treaty countries. Moreover, Avi-Yonah noted, the transfer pricing problem could actually become worse in the absence of CFC regimes. Source country tax rate convergence would be more productive than the exemption method, he concluded.

Avi-Yonah advocates source-country withholding, at the highest statutory rate, on all income arising from direct or portfolio investment regardless of whether the investor has a PE. The investor would have to file a return to be taxed on a net basis. The source country could, however, disallow costs if the investor's country of residence is a tax haven -- the point being to ensure that the income is taxed somewhere. Avi-Yonah's theory is that tax havens are just way stations, and the ultimate destination of the income that passes through them is a developed, capital-exporting country. So if income were taxed on its way out of the source country, tax havens would have no reason to exist. (Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State," 113 *Harv. L. Rev*. 1573 (2000).)

All of this was relatively straightforward. Then the discussion turned to which country should have a superior right to tax interest and royalties, keeping in mind that these items are popular means of income stripping. Participants were essentially asked to vote against article 11 of the OECD model, which taxes interest to the residence of the lender, but allows some taxation by the source country. (The U.S. model allows none.) They were then asked to allow the borrower's country to tax interest as a surrogate for business profits. They were not interested.

Figueroa argued vigorously that interest should be taxed where the capital is being used, because that is where the business income out of which the interest is paid is being earned. He would nonetheless allow a deduction for interest when it came to taxing that business income. He would withhold on the gross interest payment and ask questions later.

Bureau Chief Pascal Saint-Amans of the French Finance Ministry noted that interest is not wholly passive and that the OECD model was drafted by capital-exporting countries. He nonetheless argued that the country of the lender's residence should have the exclusive right to tax interest income because that is where the risk is. Moreover, he argued that interest has nothing to do with the borrower's gross income from its business, since the interest must be paid regardless of profits. What about tax equity? Countries forgo source taxation of interest to attract investment, Saint-Amans maintained.

Saint-Amans added that source-country taxation of interest is impractical, because it would require information that the source country does not have. Here Prof. Roy Rohatgi of India interjected that the necessary information can be had from taxpayers, the way India does it. India withholds on the gross interest income, and if the taxpayer wants to be taxed on net interest income, it must file a return. It's the taxpayer's choice whether to produce the information. Figueroa added that it's also possible to withhold on a notional net interest income.

Then we get to the contentious question of royalties, the subject of an article a couple weeks ago about whether satellite fees are properly considered royalties. (*Tax Notes Int'l*, Oct. 3, 2005, p. 7.) This debate was about who should tax items that are acknowledged to be royalties. The OECD model allows only the intangibles owner's country of residence to tax royalties. Asked whether royalties should be taxed where an intangible is produced, rather than where it is used, a resounding 61 percent of the participants said no. Of course, the question was hypothetical in that royalties are taxed nowhere now, since every country allows expensing of research and development (the equivalent of exempting the resulting income from tax).

Pinto argued that the wealth associated with royalties was created where the intangible was created, where the research and development were performed. He acknowledged that royalties have an implicit interest component, but argued that it would be impractical to disaggregate it. Figueroa argued that royalties are indistinguishable from interest in the case of older, fully amortized trademarks. Eric Kemmeren of Tilburg University, who presided over the session, would go further, whacking royalty income up into pieces: amortization, maintenance, risk, and interest. He would tax only the interest component in the country where the intangible is used. (Kemmeren, *Principle of Origin in Tax Conventions* (Dongen 2001).)

The income is produced where the intangibles are being used, Figueroa insisted, noting that most royalties are paid between related companies. Royalties are a base erosion problem for countries where intangibles are used. These often poorer countries, Figueroa maintained, are transferring wealth to richer countries that are the residences of the intangibles' owners. Tax equity, he argued, demands that source countries be permitted to tax royalty income by means of withholding at source. Should development costs be deducted? No, because they were usually already recovered in the residence country. (Strictly speaking, more than recovered -- accelerated.)

No Arguments

We're seeing a common theme here, other than immobilism: a growing awareness that the sensible approach for developing countries is to withhold now and ask questions later.

Schindel and Atchabahian suggested in their general report that this approach, combined with an exemption method, might obviate the need for tax treaties, which have strayed from their original purpose of allocation of tax jurisdiction to become instruments of tax avoidance by developed-country investors. "The resulting fiscal sacrifice is likely to exceed by far the potential benefits resulting from new investment capital," the pair warned, urging developing countries to stay away from new treaties with developed countries.

"Let's track the money," said Brazilian Agostinho Tavolaro of Tavolaro e Tavolaro Abogados, at a session on determining the amount that a source country should tax. The source country, he noted, has jurisdiction over an outgoing payment. If it withholds tax, the recipient taxpayer would obtain a tax credit in its country of residence, or that income would be exempt. There would be no double taxation, no need for treaties, no need for information exchange, and no need to pursue the taxpayer. No fuss, no muss, no arguments.

Pie in the sky? Nope. Argentina, Brazil, and Uruguay, among others, pursue this approach to some extent. Of these three, only Argentina has a treaty with the United States. Indeed, Uruguay, which relies heavily on source taxation, has only two tax treaties. Uruguay is one of 12 countries that have exclusively territorial, source taxation systems. The others are Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong, Kenya, Malaysia, Nicaragua, Panama, Paraguay, and Singapore.

Figueroa pointed out that Argentina veered away from exclusive source taxation because of the income-earning posture of its residents. That is, source/territorial taxation works best when most residents get their income from only domestic sources. Because many Argentine residents earn foreign income, much of it from tax havens, Argentina had to adopt a worldwide system to tax it, with a credit method of double tax relief. Argentina maintains a blacklist and taxes currently the income of any resident shareholder in a blacklist-domiciled company.

Nonetheless, Argentina is aggressive about defining income as having an Argentine source. Income generally has an Argentine source when the activities to earn it are undertaken in Argentina. Interest paid by an Argentine borrower has Argentine source, as do royalties paid for intangibles used in Argentina. Specific items of income, such as premiums from insurance of Argentine risks, are deemed to have an Argentine source. Argentina withholds on gross payments of most items of income. A PE in Argentina is taxed as a resident, on its worldwide income, with a credit for foreign tax paid on foreign income. Argentina does not allow deduction of head office or research and development expenses, but interest and royalties can be deducted without limit.

Brazil withholds on the gross amount of most payments made by Brazilian persons to nonresident payees, regardless of where the income was produced, services performed, or the payment made. Gross income of nonresident companies is subject to withholding on outgoing payments, with no deductions allowed, at rates ranging from zero percent to 25 percent depending on the type of income. Dividends are not taxed, regardless of whether the payee is domestic or foreign. Brazilian law has no source rules; the aim is to assert jurisdiction over the resident taxpayer.

Brazil goes beyond the PE concept to assert tax jurisdiction and has no definition of PE in its law. A branch of a foreign company is taxed as a resident. A nonresident can easily be considered resident on the basis of business activity, even in the absence of physical presence. A local sales representative having the power to bind a foreign company will provide the necessary nexus for the latter to be taxed on a net basis on its business profits. Net income is determined by looking at the sales representative's separate books, or arguing with the foreign company in arbitration. Brazil does not allow deduction of shared head office or research and development expenses.

Uruguayan-source business income is subject to a 30 percent rate. Income is deemed to have an Uruguayan source if it is derived from activities carried out, property located, or rights used within Uruguay, regardless of the residence of the taxpayer. As in Brazil and Argentina, special rules designate how much of some items, like premiums from insurance of Uruguayan risks, is deemed to have domestic source. Export income has a Uruguayan source; import income has a foreign source.

Royalties are subject to 30 percent withholding unless the payer is already subject to business income tax in Uruguay. Dividends are subject to 30 percent withholding if the payee is taxable in its country of residence and can get a tax credit. Income from technical services is generally taxable, but is exempt from withholding if the payee is taxed on it in its country of residence and receives no credit. Nonetheless, Uruguay signed onto a PE concept and reduced withholding in its treaty with Germany.

Uruguay is often regarded as a tax haven. Foreign-source income is exempt from tax, and some take the position that mixed-source income is foreign and therefore exempt. Uruguay uses separate-company accounting and respects legal entities, though the tax administrator has discretion to ignore the taxpayer's accounting when it does not accurately reflect Uruguayan-source income. There are no transfer pricing rules, so re-sourcing income to foreign subsidiaries is not difficult. Domestic-source interest is not taxed because it is not considered business income.

Of course, some of our readers may be seeing another pattern: Most of the countries that rely heavily on source taxation have good football teams. Maybe there's something to that, or maybe they're just keeping the ball on the ground.

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