

Chapter 1: International Tax Policy

1.1. Introduction

In most countries, the returns from trade and investment within national borders are subject to income taxation as a matter of course. The way in which those returns are taxed is based upon a country's domestic tax policy. International trade and investment are, in principle, no different. As technology and capital markets have developed over time, people move around more, living in different countries for periods of time and generating income in different countries concurrently. As a country's trade and commerce become increasingly more internationalized, the taxation of international transactions becomes even more important. Once an entity extends its arm beyond its national borders, it is most likely to fall within the ambit of the tax laws of another country. The way in which that country's tax laws impact on the entity will have consequences for the manner in which the entity is taxed domestically. Thus, the tax regimes of each country become interrelated.

Different countries have addressed the issue of who is liable to tax (i.e. the "taxable subject") in an international transaction or economic event (which produces a "taxable object" – normally income or capital) in different ways over time for various political, cultural and historic reasons. However, despite the methodology adopted, if a government wishes to tax transactions and economic events that occur across its borders, it needs to have some underlying policy rationale to substantiate its impost. That justification is based on its "international tax policy".

As national barriers to cross-border trade and investment broke down from the 1980s, with the resultant explosion in globalization of international business and capital flows, the tax spotlight has been shining brightly on the appropriate tax policy tools, which a government might implement to collect revenue from an increasing number of entities (both natural and legal persons), which do not fall within its jurisdiction because they are located in another country, but nevertheless derive income from the country over which the government has jurisdiction. Conversely, a government needs a tax policy framework to determine whether (and, if so, how) it should tax income of its country's entities, which is derived beyond the country's borders.

The international tax policy adopted by a country will be driven by its economic and social objectives. Ultimately, of course, for any country, decisions about international tax policies are political ones dictated by those broader economic and social imperatives. But those decisions must be informed by proper consideration of different – and often conflicting – international tax policy choices.

This chapter examines various international tax policy approaches and what they are designed to achieve. In large part, international tax policy is determined by whether a country is a net capital importing country (i.e. it is dependent on investment by foreigners for its economy to grow; in other words, in net terms more capital is invested in the country by foreigners than locals are investing overseas) or whether it is a net capital exporting country (i.e. it is a wealthy country the people, government and private sector entities of which are investing their surplus wealth offshore – more is being invested overseas by locals than foreigners are investing in the country).

The objectives of this chapter are to explain the notion of "international tax" and to give you an insight into the principles that underlie rational international tax policy.

We examine the primary aims of international tax policy and how they are achieved in relation to outward investment from a country and investment into a country. The principles of capital export neutrality and capital import neutrality are discussed.

1.2. International tax

What is "international tax"? International tax is best regarded as the body of legal provisions of different countries that covers the tax aspects of cross-border transactions. International tax, in this sense, is concerned with direct taxes (i.e. income taxes, estate taxes, gift taxes, wealth taxes and social security contributions) and indirect taxes (i.e. value added – or goods and services – taxes, sales taxes and customs duties).

International tax can also be regarded as a subset of the broader notion of “international law”. This perspective is particularly relevant in the context of double tax treaties. However, there is no definitive, overarching international tax law applicable to countries that choose to comply with it. In that sense, the phrase “international tax” is something of a misnomer: it is the international tax laws of a particular country (including its international tax treaties) that we are talking about when we refer to “international tax” and “international tax law”. Those laws can be imposed by a country at its federal, national, state or local government level. Most often the tax impost on international transactions is imposed at the national level.

There is, however, a significant exception to this notion: the European Union imposes directives upon its 28 separate Member States, which govern, inter alia, how certain transactions between taxable subjects of one Member State with taxable subjects of another Member State are to be treated for tax purposes. For example, the [Sixth Directive](#)^[1] sets out rules about the imposition of value added tax on cross-border transactions between the Member States. Similarly, the Parent–Subsidiary Directive^[2] and the [Savings Directive](#)^[3] specify rules about the imposition (or non-imposition) of income tax on cross-border transactions (of the types addressed in the directives) between the Member States.

The generally accepted convention under international law is that, while a country is free to levy tax however it chooses, it cannot enforce its tax claims on the territory of another country. In other words, its taxing jurisdiction cannot extend to imposing its tax on taxable objects that arise in another country. For example, France cannot levy its tax on Germans who derive all of their income from Germany. Therefore, typically a country’s tax laws are confined to taxable subjects and objects that have some sort of connection with the country. Those tax laws normally cover two kinds of activities:

- (1) the activities of a resident of that country in foreign countries; and
- (2) the activities of a non-resident in that country.

We shall return to this distinction in more detail in [chapter 2](#).

1.3. Objectives of international tax rules

There are generally five primary objectives underlying a country’s incorporation of international tax rules into its tax legislation:

1.3.1. National wealth maximization

On a taxation level, national wealth maximization means that a country tries to ensure that it gets its fair share of revenue from cross-border transactions to enhance the well-being of its citizens, and in doing so maintains its domestic tax base. Since the way international transactions are taxed ultimately determines the allocation of the tax imposed between the two (or more) states involved in the international transaction(s), national wealth maximization requires that a country maximizes its share of that impost. National wealth maximization encompasses (a) both the private return that is obtained by an investor that invests abroad *and* the tax revenue that the investor’s government collects from that investor in respect of the foreign investment, and (b) the tax revenue that the government collects from foreign investors that invest in its country.

More broadly, national wealth maximization involves increasing the wealth of a country by expanding its economy. To do so, some countries (particularly developing countries) introduce tax incentives to encourage foreign investment, with the aim of increasing jobs and facilitating economic growth through a “multiplier effect”. Such tax policies are valid only so long as the acceleration effects of the tax incentive induced investment create direct and indirect economic benefits which outweigh the long-term cost of tax revenue that is lost as a result of the provision of the tax incentives.

1.3.2. Tax equity

Tax equity or fairness is all about imposing equal taxes on taxpayers with equal income or equal ability to pay without reference to the source or type of income and the legal structures through which the income is derived. A country has

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1. Council Directive [2006/112/EC](#) of 28 November 2006 on the harmonization of the laws of the Member States relating to turnover taxes – common system of value added tax: uniform basis of assessment (as amended).
 2. Council Directive [90/435/EEC](#) of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (as amended).
 3. Council Directive [2003/48/EC](#) of 3 June 2003 on taxation of savings income in the form of interest payments (as amended).

the option of imposing its notion of fairness on its residents (by taxing all of their worldwide income), but it cannot impose the same standard of fairness on non-residents because it does not have the ability to tax income of non-residents that arises outside the country.

1.3.3. Economic efficiency

Economic efficiency is concerned with developing the competitiveness of a country's economy, ideally by ensuring that taxation does not drive a wedge into optimal investment decision-making. This means that, because investors will make investment decisions that generate the maximum return to them, the tax impost on the pre-tax return from an investment should not distort the after-tax return on the investment and thereby create a bias in the investor's decision-making process. For an unbiased outcome to be achieved, the imposition of tax must be neutral as between the array of different domestic and foreign investment options, which faces an investor.

Tax incentives that favour foreign investment (see [section 1.3.1.](#)) compromise economic efficiency at an international level, i.e. while the country that offers the incentive may be better off, *ceteris paribus*, that country and another country that offers a better pre-tax return, taken together, will be worse off. In other words, the gains to the former country are outweighed by the losses to the latter country. At the same time, a country will want to avoid tax measures that undermine its competitive position in the world economy, i.e. it will want to avoid adopting international tax rules that draw capital^[4] and skills out of the country or discourage the importation of capital and skills.

1.3.4. Administrative efficiency

As in the case of setting domestic tax policy, the above international tax policy objectives are formulated within the context of minimization of compliance and administrative costs, i.e. a government that wishes to adopt sound international tax policies will try to ensure that taxpayer compliance and the tax authorities' administrative costs are minimized when the policy becomes operational. Compliance costs are "dead-weight" costs, i.e. costs to the economy arising from the imposition of a tax. Different international tax policies will have different levels of dead-weight costs. For example, international taxation of foreign source income on an accrual basis, which distinguishes between black, white and grey list countries,^[5] will impose greater taxpayer compliance costs and administrative costs than a policy that does not require such differentiation or a simpler policy that merely exempts foreign source income from the tax base of an investor's country.

1.3.5. International compatibility

It is generally desirable that a country's international tax rules are compatible with those of other countries. In our globalized economy, where capital freely flows between most countries, a sensible government would not want to impose significantly harsher international tax rules on investors into its country than those implemented by other countries, which results in an outflow (or minimal or no inflow) of resources from (into) the country. Furthermore, where a country's international tax rules are not compatible with those of other countries, arbitrage opportunities are created whereby tax planners can arrange international transactions to take advantage of the asymmetric international tax regimes to the detriment of the tax base of (at least) one of the countries through which the transactions take place.

In addition, business and foreign investor certainty is enhanced if a country's tax rules are compatible with those of the country (or countries) with which the foreign investor is already familiar, such as its home country. It also does not make a lot of sense for small capital importing countries to adhere strictly to a policy of capital export neutrality^[6] to achieve the most efficient worldwide allocation of resources when that country has negligible outward investment and other countries adopt a more relaxed international tax policy position. So, in reality, in setting its international tax policies a country must take account of the policies adopted by other countries, particularly its major trading partners and (especially if it is a capital importing country) the countries that compete for the capital investment that it seeks.

1.3.6. Conflicts between objectives

The objectives of international tax policy may well conflict, in which case a government must decide which objectives are to prevail in the light of the broader social and economic aims which it is trying to achieve for the citizens of its

4. In this context, "capital" refers to all types of investments in assets, which are intended to produce a monetary return to the investor.

5. See [section 1.5.2.1.](#)

6. See [section 1.5.1.](#)

country. For example, a coherent national wealth maximization policy may require that investors of a country who invest abroad pay tax in their home country on an accrual basis (rather than when the income is remitted to their home country). Such a requirement meets the tenet of tax fairness (because it puts such investors on the same footing as those who invest domestically), but it involves more complex international tax laws, greater taxpayer compliance costs, and more comprehensive tax administrative procedures, all of which compromise the objective of administrative efficiency.

1.4. Taxation of inward investment

1.4.1. Capital import neutrality

To achieve the goals of tax equity and economic efficiency, a country needs to adopt a strategy of capital import neutrality. As the name suggests, the tax regime must be neutral in the way that it taxes income derived by suppliers of investment capital; that is, a country's international tax rules need to be concerned about the way in which foreign investors and local investors (respectively), who invest in the country, are taxed.

The way in which investments made in a country are taxed will affect the behaviour of both foreign and domestic investors. If foreign investors into a country are taxed in a different manner from local investors who make the same investments in the country, the tax system will be unfair and distort investment behaviour.

Capital import neutrality is designed to achieve neutrality between the way that income derived from imported capital from foreign investors is taxed and the way that income derived from capital invested by local investors is taxed. Capital import neutrality therefore means that all investors in a country (whether foreign or domestic investors) face the same effective tax rate on income from their investments, which is sourced in the country. Clearly, capital import neutrality does not occur where a country imposes different tax rates on domestic source income, depending on whether the taxpayer is a local or foreign investor. This typically comes about when the country offers a tax exemption to foreign investors in order to indirectly increase the country's national wealth. However, doing so breaches the tenets of both tax equity and economic efficiency. As to tax equity, local investors will complain that it is unfair that they must pay tax when foreigners who are earning the same income from the same types of investments are not required to pay tax, particularly if the local investors' capital is in an immovable form. Local investors of movable capital will arrange their affairs such that the capital is transferred to a foreign entity and reinvested back into the country from abroad.

Economic efficiency is jeopardized where capital import neutrality is absent from a country's international tax policy because foreign investors have a competitive advantage via a lower cost structure, which does not contain a tax cost element.

A good illustration of these sorts of problems is the experience in China, which offered qualifying foreign investors a "tax holiday" for up to 10 years in respect of certain investments made in China. The same benefit was not extended to Chinese investors who made the same sorts of investments. The Chinese investors complained about their inequitable tax treatment, and often established offshore entities to which they transferred their investment capital. Those entities then reinvested the capital back into China and qualified for the tax exemption as foreign investors. Furthermore, the tax exemption available to foreign manufacturers (including the Chinese-owned foreign entities) gave them a competitive advantage over domestic manufacturers, which distorted the efficient allocation of resources.^[7]

1.4.2. Other policy considerations

Subject to any specific tax exemptions that a country may offer to foreigners, foreigners are generally taxed on income that they derive from a country if that income has a source in the country.^[8] Whether or not an item of income has a source in a particular country generally turns on that country's domestic tax law notion of where income is derived. Therefore, it is not uncommon to read in domestic tax statutes rather long lists of different sorts of income that are deemed to have a source in the country for income tax purposes. For example, Sec. 69 of the Tanzania Income Tax Act 2004 states that:

The following payments have a source in the United Republic [of Tanzania]:

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7. On 13 March 2007, the Chinese National People's Congress passed the Enterprise Income Tax Law, which phases out these kinds of tax preferences for foreign investors, thus more closely aligning to a policy of capital import neutrality.
 8. The source jurisdiction of taxation is discussed in more detail in [section 2.2.1](#).

- (a) dividends paid by a resident corporation;
- (b) interest paid by a resident person or domestic permanent establishment;
- (c) natural resource payments made in respect of or calculated by reference to natural resources taken from land or the sea situated within the United Republic or its territorial waters;
- (d) rent paid for the use of, right to use or forbearance from using an asset situated in the United Republic;
- (e) royalties paid for the use of, right to use or forbearance from using an asset in the United Republic;
- (f) premiums for general insurance paid to and proceeds from general insurance paid by a person in respect of the insurance of any risk in the United Republic;
- (g) payments received by a person who conducts a business of land, sea or air transport operator or charterer in respect of –
 - (i) the carriage of passengers who embark or cargo, mail or other moveable tangible assets that are embarked in the United Republic, other than as a result of transshipment; or
 - (ii) rental of containers and related equipment which are supplementary or incidental to carriage referred to in subparagraph (i);
- (h) payments received by a person who conducts a business of transmitting messages by cable, radio, optical fibre or satellite or electronic communication in respect of the transmission of messages by apparatus established in the United Republic, whether or not such messages originate in the United Republic;
- (i) payments, including service fees, of a type not mentioned in paragraphs (g) or (h) for or attributable to employment exercised, service rendered or a forbearance from exercising employment or rendering service –
 - (i) in the United Republic, regardless of the place of payment; or
 - (ii) where the payer is the Government of the United Republic, irrespective of the place of exercise, rendering or forbearance;
- (j) proceeds of life insurance and retirement payments not falling within paragraph (i) (the “return”) paid by a resident person or a domestic permanent establishment and any premium or retirement contribution paid to a resident person or domestic permanent establishment to secure such a return;
- (k) gifts and other ex gratia payments to the extent received in respect of business or investment conducted with domestic assets; and
- (l) payments not mentioned in the above paragraphs made in respect of –
 - (i) the acquisition of a domestic asset, incurring of a domestic liability or realisation of such an asset or liability; or
 - (ii) activity conducted or a forbearance from conducting activity in the United Republic.

Typically, once the domestic law identifies a source within the country the income arising from it is taxed in one of two ways. First, the foreigner is required to file a tax return in the same way as residents of the country (usually annually) and pay tax on the net income that the foreigner derives from the country. Note that here tax is levied on *net* income, being the difference between gross income and deductible expenditure. Alternatively or additionally, the foreigner may be required to pay withholding tax at source.

1.4.3. Non-resident withholding taxes

Payment of withholding tax means that tax is deducted at the time that the income is paid to the foreigner by the payer in the country of source of the income. Where passive income (i.e. income that does not involve productive activity, such as dividends, interest and royalties) is derived by a foreigner from a country, non-resident withholding tax is normally imposed at source and is treated as a final tax on that income. In this case, the tax is levied on the *gross* amount of

income paid. Since income tax is levied on the net amount of income earned and withholding tax is levied on the gross amount of income paid, withholding tax rates are normally lower than income tax rates.

Non-resident withholding taxes have the advantages of:

- the taxpayer avoiding the compliance costs associated with having to file an annual tax return, where the withholding tax is a final tax;
- early collection of tax by the government; and
- ensuring that tax is collected from the paying party, which is within the country's legal jurisdiction, should the recipient otherwise wish to evade its tax obligations in that country.

Frequently, both methods of taxation apply, i.e. withholding tax is deducted at source *and* the taxpayer must also file a tax return. In this case, the withholding tax deductions are not final taxes, but merely tax paid provisionally or on account of determination of the taxpayer's annual tax liability at the end of the year. The withholding tax deducted during the year is credited against the taxpayer's annual tax liability ascertained in the return, leaving the taxpayer with a balance of tax to pay or a tax refund at the end of the year. This approach frequently applies to foreign employees and independent contract service suppliers who are often entitled to personal and other deductions and/or tax rebates, the correct allowance of which is not easily accommodated by a final non-resident withholding tax regime.

Clearly, a country should not set its tax rates, including its non-resident withholding tax rates, applicable to foreign investors at a level so high as to deter foreign investment in the country and to distort the cost of capital structure in the country's economy. This is particularly important for small, open capital importing countries, which are in effect price takers on world capital markets.

Example 1.1.

To illustrate the point, suppose that a foreign investor is deciding whether to invest in bonds issued by its home country, Country R, or in bonds issued by another country, Country S. If a 10% post-tax return could be obtained in Country R, the investor would require, *ceteris paribus*, the same return from Country S after imposition of Country S' tax on the foreign investor if it were to invest in Country S.⁹

If the investment were USD 1,000 and Country S levied a 30% tax on the interest income from the bonds, the issuers of the bonds in Country S would need to pay USD 142.86 to persuade foreign investors to buy their bonds, thereby leaving the foreign investors with a 10% after-tax return from Country S – which equals the return that they could otherwise have obtained by investing in bonds issued in Country R, i.e.

Country S	USD
Investment in bonds	1,000.00
Interest on bonds	142.86
Less: Country S tax (30% × USD 142.86)	(42.86)
After-tax income	100.00
After-tax return ($\frac{100}{1,000} \times 100\%$)	10%

The post-Country S tax rate of return on interest to foreign investors is the same regardless of the tax rate that Country S imposes. In other words, Country S' tax rate is not *borne* by the foreign investor. It is borne by the borrowers in Country S: as a consequence of Country S' tax wedge, the interest cost to Country S' borrowers is not 10%, but 14.29%. Furthermore, because bonds issued in Country S are offered to all investors – regardless of whether they are foreign or domestic investors – this 14.29% return is available to all investors, foreign and domestic. The tax impost has therefore increased the cost of capital in Country S, which has adverse macroeconomic consequences for the government and all citizens of Country S in terms of higher interest rates, and the levels of investment, wages and employment. Therefore, Country S needs to ensure that its tax impost is not so high as to adversely impact upon its cost of capital structure. For this reason, some tax policymakers and economists argue that foreign investors should be taxed at minimum levels, which leads to a conflict with the notion of capital import neutrality if Country S' own investors are not taxed at the same rate on their domestically sourced investment income.

1.5. Taxation of outward investment

1.5.1. Capital export neutrality

Capital import neutrality focuses on ensuring that a country imposes the same amount of tax on the income of foreign investors and local investors from equal investments made *in* the country. But a country's international tax rules also need to be concerned about the way in which it taxes its own resident investors, which are free to choose between

9. Assume, for simplicity, that Country R exempts foreign source income from taxation: see [section 2.4.1](#).

In explanations throughout this book, "Country R" refers to the country in which a taxpayer is a resident and "Country S" refers to the country from which that taxpayer's foreign sourced income is derived. Furthermore, the terms "Country R" and "State R" and "Country S" and "State S" are used interchangeably throughout the book.

investing at home or abroad. The investment behaviour of a country's own investors will be affected by the way in which their investments are taxed in their home country.

Therefore, to achieve the goals of tax equity and economic efficiency, a country needs to adopt a strategy of capital export neutrality. As the name suggests, the tax regime must be neutral in the way that it taxes income derived from exported capital vis-à-vis the way that it taxes income derived from the same capital that could otherwise be invested domestically, i.e. in the local economy of the country. Looking from the viewpoint of tax payable in the country in which investors are resident,^[10] capital export neutrality therefore means that those investors face the same effective domestic tax rate whether they invest at home or abroad. Only then does the country's tax system neither encourage nor discourage outflows of capital from the country, allowing the investor to choose to locate his investment where he derives the greatest (pre-tax) returns. In other words, the tax system is neutral between investors of a country investing at home or abroad because the investors are taxed at home the same way, regardless of where they choose to invest: foreign source and domestic source income are taxed in the same way. To attain capital export neutrality, a country's residents must be taxed on their worldwide income. If they are not – for example, if foreign source income is not taxed under a "territorial" system of taxation – the tax system produces a bias in favour of investing overseas: economic efficiency is therefore compromised. In addition, domestic investors who are constrained to investing their capital in the country (because it is not readily movable, such as land) will complain that they are being treated inequitably by the country's international tax regime.

Example 1.2.

Assume that the rate of return on investments in a country is 10% p.a. and the rate of return that an investor of that country could obtain by making her investment in another country is 8%. In a tax-free world, ceteris paribus, the rational investor would make her investment domestically rather than abroad because that is where she will earn the greatest return. That decision will result in the most efficient allocation of the investment resource, as determined by the market rate of return. In an economics sense, the market indicator of efficiency is the pre-tax returns, which investees are willing to offer.

Now assume that the investor's home country imposes a 30% tax rate on income derived by its residents. If the country pursues a policy of capital export neutrality, it will tax its residents on all of their income, notwithstanding its source. The investor will again invest domestically because the pre-tax return of 10% (being subject to the country's 30% tax impost) is reduced to a post-tax return of 7%. Whereas if the investment were made abroad, the pre-tax return of 8% (also being subject to the home country's 30% tax impost) is reduced to a post-tax return of 5.6% (i.e. $8\% - [30\% \times 8\%]$), which is still a lower return than that applicable to the domestic investment. Again, this result produces the most efficient allocation of the investment resource, as determined by the market rate of return indicator, because tax has been imposed in a uniform manner to the pre-tax market returns from each investment option.

If, however, the home country does not embrace capital export neutrality, and (say) exempts foreign source income, the investor's decision will then be influenced by the uneven tax impact on the returns. The investor will now invest abroad because the domestic post-tax return is 7% (as determined above), but the foreign investment return, not being subject to the home country's tax impost, remains at its original level of 8%. Such a switch in investment strategy, as a result of the inconsistent application of taxation to the pre-tax returns, no longer results in the most efficient allocation of resources. The market indicator of the best returns points in one direction (i.e. to invest domestically), while the tax wedge changes that indicator in favour of investing abroad. In other words, the best utilization of the investment capital according to the market is not selected. The country's international tax regime in this case has brought about a misallocation of resources.

To summarize, where capital export neutrality prevails, a country's international tax rules will not influence the investor's decision one way or another, in which case the rational investor will seek the investment that gives her the greatest return, thus ensuring the most efficient allocation of resources. Therefore, ceteris paribus, capital export neutrality allows capital to be allocated globally in the most efficient way by giving investors the highest, risk adjusted returns on their investments.

^{10.} See [chapter 2](#) for a detailed discussion of the concepts of residence and residence based taxation.

1.5.2. Other policy considerations

Governments usually want to tax income that local investors derive from investments that they make abroad, i.e. outward investment from the country and do so by taxing their residents on their worldwide income. Rational business people see tax as a cost of doing business or investing, and seek to minimize that cost wherever it is legitimately possible to do so. A standard technique by which investors can avoid tax in their home country on their foreign source income is to establish a separate legal entity (a company or a trust) in a foreign low or no-tax jurisdiction, and to divert and retain in the foreign entity income from international transactions or investments, which would otherwise be derived directly by the investor, and constitutes part of her worldwide income, which gets caught in the home country's tax net. The incentive for investors to act in this way is accentuated when the home country imposes relatively high tax rates, cf. the tax rates imposed in the country from which the income is derived.

Governments, on the other hand, need to maintain their tax bases. Therefore, the domestic tax law of a country often contains provisions to capture these sorts of arrangements. These laws are essentially anti-avoidance rules. They sometimes distinguish between an investor's foreign direct investment ("FDI" or "non-portfolio" investments) and her "portfolio" investments. The former indicates a significant investment in a particular foreign entity, and is typically more applicable to corporate entities (rather than individuals), which might conduct global business operations through a network of subsidiary companies in different countries. The latter refers to a relatively smaller investment, which is one of a portfolio of (usually) many investments. A common demarcation threshold is a 10% interest in the foreign entity, i.e. if the investors' interest in the foreign entity is 10% or more, the investment is treated as a non-portfolio investment; if the investment involves a less than 10% interest, it is treated as a portfolio investment. Non-portfolio investments tend to be the target of international tax avoidance rules.

1.5.2.1. Controlled foreign companies

The taxation of non-portfolio investments is addressed by controlled foreign company (CFC) legislation. Broadly, where there is a sufficient level of control of the CFC by local investors, the income of the CFC is simply attributed to the local investors, notwithstanding that, from a legal perspective, the income was derived by a company which is outside the taxing country's jurisdiction.

Example 1.3.

Company R, which is a resident of a country (Country R), incorporates a subsidiary company (Company H) in a tax haven country. Income from international business transactions and foreign investments, which would otherwise have been derived directly by Company R, is now diverted to Company H.

The profits of Company H may be invested or spent by it so that they are never subject to tax in Country R. Even if the income is ultimately distributed by Company H by way of a dividend paid to Company R, which is taxable to Company R, Company R obtains the timing benefit from deferral of the dividend distribution to a later income year. Compare that to the situation where Company H was not established, viz. taxation of the income in Company R's hands in the year that it is derived.

CFC legislation, enacted by Country R, is intended to bring the profits from international transactions, which are trapped in Company H, within Country R's tax net for the year in which they are derived. This is done by attributing Company H's profits to Company R (in proportion to Company R's shareholding interest in Company H) in the year that the profits are earned by Company H, whether or not those profits are actually distributed in that year.

In designing their CFC regimes, some countries compile lists of countries that:

- always fall outside the scope of the CFC rules because their tax impost is comparable to that of the home country ("white list");
- always fall within the scope of the CFC rules, such as tax havens, because their tax impost is always considerably lower than that of the home country ("black list"); and

- fall within the CFC rules only under certain conditions, e.g. when particular entities or income are treated preferentially in a foreign country with an otherwise comparable tax impost to that of the home country (“grey list”).

Countries that have enacted CFC legislation include Australia, Canada, Denmark, Finland, France, Germany, Hungary, Italy, Japan, New Zealand, Norway, Portugal, Spain, Sweden, the United Kingdom and the United States.

The effect of CFC legislation is to tax foreign source income on an accrual basis (i.e. in the year in which the income is earned), instead of on a receipts basis (i.e. in the year that the income is remitted from the foreign entity to the investor’s home jurisdiction). In this sense, CFC legislation is concerned with the timing of recognition of income for tax purposes in the home country. CFC rules are intended to bring forward the year in which that taxation is levied.

1.5.2.2. Active/passive income distinction

Since a CFC regime is essentially a tax avoidance rule, often the legislation is targeted only at CFCs that are resident in a tax haven country or at “passive” investment income, viz. dividends, interest and royalties, which arises from capital that is readily movable from country to country. Therefore, we find that CFC legislation is generally not directed at companies that are actively and legitimately pursuing some income producing undertaking in a foreign jurisdiction. In these cases, the CFC legislation embodies an active income exemption. This means that income generated abroad from active business pursuits is not taxed on an accrual basis in the investor’s home country, but that income may be taxed when it is remitted to the home country, while foreign passive investment income remains subject to tax on an accrual basis. The policy intent behind this approach is to allow legitimate international business activity to proceed unencumbered by undue interference by the home country’s tax system. The active/passive income distinction also typically involves less compliance costs than an all-encompassing application of CFC legislation.

1.5.2.3. Portfolio investments

Since CFC legislation deals with foreign *companies*, some countries have also incorporated further measures in their domestic legislation to catch in a similar way other controlled foreign vehicles, such as investment funds (sometimes referred to as “foreign investment funds”) and trusts. Where an investor has an interest in such a foreign entity, income that is attributed to the investor by her home country can be determined in a variety of ways (which are not mutually exclusive), including:

- by simply allocating to each investor her pro-rata share of the income derived by the entity (whether or not that income is distributed);
- on an unrealized accrual basis by treating as income the difference between the market value of the entity at the beginning and at the end of the income year;
- by imputing a deemed rate of return on the investment in the entity; and
- by the amounts actually distributed by the entity, which are taxed at a higher rate in the recipient’s hands to counter the tax benefit that arose from the deferral of the distribution. This method is used, in particular, to tax beneficiaries of foreign trusts, the trustees of which are located in tax havens or low-tax jurisdictions.

1.6. Conclusion

In this chapter we have discussed the principles that form the foundation of good international tax policy. We have examined the five fundamental policy objectives, viz. national wealth maximization, tax equity, economic efficiency, administrative efficiency and international compatibility, and noted that there is a trade-off between them. This chapter also considered the need for capital import neutrality and capital export neutrality to ensure that the tax system does not intervene in an investor’s optimal decision making process by undermining the objectives of tax equity and economic efficiency.

We have looked at policies to tax the returns from inward investment into a country, particularly by reference to identification of income having a source in the country and the imposition of withholding taxes as well as (annual) income taxes. Finally, this chapter addressed the typical ways in which a country taxes returns from outward investments made by its investors.

The key concepts introduced in this chapter were:

- taxable subject;
- taxable object;
- international tax;
- national wealth maximization;
- economic efficiency;
- administrative efficiency;
- international compatibility;
- capital export neutrality;
- capital import neutrality;
- non-resident withholding tax;
- controlled foreign companies;
- active and passive income; and
- portfolio investments.

Review questions

1. Distinguish between a “taxable subject” and a “taxable object”.
2. Explain what you understand by the term “international tax”.
3. What are five main objectives of international tax policies? Why might they conflict?
4. What do we mean by “outward investment”? Discuss the main ways in which a country can tax returns from outward investments made by its investors.
5. What do you understand by the term “inward investment”? How does a country tax returns from inward investment?
6. What does the term “capital import neutrality” mean? How is it different from “capital export neutrality”?
7. Explain how high rates of tax on foreign investors can increase the cost of capital in a capital importing country. If the country’s government responded by imposing no tax on the income derived from the country by foreign investors, how would you expect the country’s domestic investors to react? How might the government then tax those investors?