CHAPTER 4

Double Taxation Relief

4.1 INTRODUCTION

As discussed in Chapter 2, most countries tax their residents on their worldwide income and nonresidents on their domestic source income. Consequently, foreign source income earned by a resident of a country may be taxed by both the country in which the income is earned (the source country) and the country in which the taxpayer is resident (the residence country). If income tax rates are low, as they were in the early years of the last century when income taxes were in their infancy, the inefficiencies and unfairness caused by this double taxation may be tolerable. But when tax rates reach the levels that now prevail, double-tax burdens can become onerous and interfere substantially with international commerce. The necessity for the relief of international double taxation is clear on grounds of equity and economic policy. However, the type of relief that is appropriate is a controversial question.

International double taxation can arise in a variety of ways. The following three types of double taxation arise from overlapping claims by two or more countries to tax the same income:

- *Source-source claims*. Two countries assert the right to tax the same income of a taxpayer because they both claim that the income is sourced in their country.
- *Residence-residence claims*. Two countries assert the right to tax the same income of a taxpayer because they both claim that the taxpayer is a resident of their country. A taxpayer that is a resident of two countries is commonly referred to as a "dual-resident taxpayer".
- *Residence-source claims*. One country asserts the right to tax foreign source income of a taxpayer because the taxpayer is a resident of that country, and another country asserts the right to tax the same income because the income arises or has its source in that country.

Of these three types of international double taxation, overlapping residence-source claims are the most likely to occur. To some degree, taxpayers can minimize their exposure to the other types of double taxation through careful tax planning, but residence-source double taxation is difficult for taxpayers to avoid through tax planning. Therefore, the attempts of the international tax community to deal with international double taxation have focused primarily on the elimination of residence-source conflicts.

International double taxation can also occur due to differences in the way countries define income and in the timing and tax accounting rules they adopt for computing income. As explained in Chapter 6, international double taxation may also occur due to disputes between countries about the proper arm's-length prices for cross-border transfers of goods and services between related parties. Other rules adopted to curtail tax avoidance can also produce double taxation. For example, if one country denies the deduction of interest paid by a resident corporation to a shareholder in another country pursuant to **thin capitalization rules** and treats the interest paid as a dividend, the amount may be taxable in both countries, as a dividend subject to withholding tax in one country and as interest included in a resident's income by the other country.

Typically, tax treaties provide relief from the three major types of international double taxation, and from some of the other types as well, although the relief is sometimes limited. Some cases of double taxation resulting from overlapping claims based on the source of income are dealt with by explicit rules for the source of income. For example, Article 11(5) of the OECD and UN Model Treaties provides a rule that interest is deemed to arise (i.e., have its source) in the country in which the payer is resident. As noted in Chapter 2, section 2.3.1, however, most tax treaties do not contain extensive source rules. Cases involving source-source double taxation that are not resolved by the specific provisions of a treaty may be resolved through consultation between the competent authorities of the two treaty countries under the treaty's mutual agreement procedure. See Chapter 8, section 8.8.3 for a discussion of the mutual agreement procedure. Resolution of such issues is not easy because the competent authorities of most countries are naturally reluctant to give up their country's right to tax domestic source income.

Individual taxpayers almost always obtain relief from international double taxation resulting from dual residence through the tiebreaker rules in tax treaties. Cases involving the dual residence of legal entities are also resolved by treaty. As discussed in section 2.2.3, Article 4(2) of the OECD and UN Model Treaties provides a series of "tie-breaker" rules to resolve cases in which an individual is resident in both countries. The dual residence of a legal entity is resolved under Article 4(3) the OECD and UN Model Treaties by deeming the entity to be resident in the country where its place of effective management is located. The mutual agreement procedure is sometimes used to deal with dual-residence cases that are not resolved explicitly in the treaty. Since dual-resident entities are often used to avoid tax, some bilateral tax treaties deny treaty benefits to such entities.

Ordinarily, the residence country grants relief from double taxation resulting from the imposition of tax on the same item of income by both the residence country

and the source country. In other words, the source country's right to tax on the basis of the source of the income has priority over the residence country's right.

Three methods – the **deduction method**, the **exemption method**, and the **credit method** – are commonly used for providing relief from double taxation. These methods are discussed in section 4.3 below after a brief explanation of what is meant by the term "international double taxation".

4.2 INTERNATIONAL DOUBLE TAXATION DEFINED

The term "double taxation" is used in so many different contexts that any precise definition of the term is not appropriate in all contexts. The term is not defined in the OECD or UN Model Treaties or in the Commentary on those Models, although they identify one of their main objectives as "the avoidance of double taxation with respect to taxes on income and on capital".

"*International double taxation*" can be defined as the imposition of income taxes by two or more sovereign countries on the same item of income (including capital gains) of the same taxable person for the same period. This juridical or legal definition of international double taxation is narrow and does not cover many situations that commentators frequently refer to as double taxation, although it does identify the essential ingredients of international double taxation. Even so, under this definition, it is not always easy to determine whether double taxation exists in a particular case. For example, questions may arise as to whether the taxes levied by the two countries are both income taxes or whether the items of income subject to tax are the same.

The legal definition of international double taxation should be distinguished from the broader economic concept of double taxation. Economic double taxation occurs whenever there is multiple taxation of the same item of economic income. Under the legal definition, taxation of a subsidiary company by one country and taxation of the parent company on a dividend from that subsidiary by another country is not international double taxation because the two companies are separate legal entities. In the economic sense, however, the parent and the subsidiary constitute a single enterprise. Economic, but not legal, double taxation also may arise when income is taxed to a partnership and to the partners or when it is taxed to a trust and to the beneficiaries of the trust.

Methods for relieving international double taxation are primarily focused on legal double taxation rather than economic double taxation. The reason double taxation relief is limited to legal double taxation is that the definition of economic double taxation is exceedingly broad and difficult to specify with the precision needed for tax laws. For example, some economic double taxation occurs when income is taxed when earned and again when consumed, yet no country is prepared to extend double taxation relief to sales taxes or other consumption taxes. Similarly, countries are not prepared to grant relief from the economic double taxation resulting from the imposition of both an income tax and an estate or wealth tax. However, double taxation relief is sometimes extended to economic double taxation where taxes are paid by foreign

subsidiaries and other foreign affiliates of a resident parent corporation despite the fact that the taxes are not paid by the parent.

International double taxation should be distinguished from the double taxation of an item of income by a single country, which might be termed "domestic double taxation". Domestic double taxation may arise, for example, with respect to income earned by a corporation and distributed to its domestic shareholders under the so-called **classical method** of corporate taxation. It may also arise when tax is imposed on the income of a person by both the central government of a country and one or more of its political subdivisions. Double taxation by national and sub-national governments is not necessarily objectionable – indeed, when the levels of taxation are properly regulated to avoid excessive tax burdens, such double taxation may be an inevitable feature of fiscal federalism.

4.3 RELIEF MECHANISMS

No international consensus has been reached on the appropriate method for granting relief from international double taxation. The following three methods are in common use. Most countries use all three methods for different types of international double taxation; a country may use only one of these methods, or it may use some combination of methods:

- *Deduction method*. The residence country allows its taxpayers to claim a deduction in computing income for taxes, including income taxes, paid to a foreign government in respect of foreign source income.
- *Exemption method*. The residence country exempts foreign source income derived by its residents from residence country tax.
- *Credit method*. The residence country provides its resident taxpayers with a credit for income taxes paid to a foreign country against residence country taxes otherwise payable. Under the credit method, foreign taxes are deductible in computing the tax payable to the residence country but not in computing the taxpayer's income.

Foreign source income earned by residents of a country that uses the deduction method is taxable at a higher effective rate than it would be under either the credit method or the exemption method. The exemption method and the credit method typically give equivalent results whenever the effective foreign tax rate is equal to or greater than the domestic effective tax rate. The exemption method is generally the most favorable to the taxpayer when the foreign effective tax rate is less than the domestic effective tax rate. The basic results under the three methods are illustrated by the following example.

Example

R, a resident of Country A, earns 100 of income from Country B on which she pays 40 of tax to Country B. Under the *deduction method*, R will pay tax to Country A on net income of 60 (100 – 40). The foreign tax paid to Country B of 40 is deductible in

computing R's income subject to tax in Country A. Assuming that R is taxable in Country A at a rate of 50 percent, she will pay tax of 30 to Country A and a total tax of 70 on her income of 100, for a combined foreign and domestic rate of 70 percent. If Country A uses the *credit method*, R's tax liability to country A (before any foreign tax credit) will be 50 percent on her total worldwide net income (100) with no deduction for the taxes paid to Country B. However, she will receive a credit against the tax otherwise payable to Country A for the taxes paid to Country B of 40. The foreign tax paid of 4 is deductible against the tax payable to Country A. The result is that R will pay tax to Country A of only 10 (50 – 40) and total tax of 50, for a combined foreign and domestic effective tax rate of 50 percent. Finally, if Country A uses the *exemption method*, R will pay no tax to Country A in respect of the foreign source income earned in Country B, and the total tax payable on the income will be 40, for a combined foreign and domestic rate of 40 percent. These results are summarized in Table 4.1.

Table 4.1 Comparison of Methods for Relieving Double Taxation

	Deduction Method	*Credit Method*	*Exemption Method*
Foreign source income	100	100	100
Foreign tax (40%)	40	40	40
Deduction for foreign tax	40	nil	nil
Net domestic income	60	100	nil
Domestic tax before credit (50%)	30	50	nil
Less: foreign tax credit	nil	40	nil
Final domestic tax	30	10	nil
Total domestic and foreign tax	70	50	40

Additional information on the operation of the deduction, exemption, and credit methods is provided below in sections 4.3.1, 4.3.2, and 4.3.3, respectively, and the exemption and credit methods are compared in section 4.3.4. Section 4.3.5 examines some of the effects of tax treaties on double-taxation relief.

4.3.1 Deduction Method

Countries using the deduction method tax their residents on their worldwide income and allow those taxpayers to take a deduction for foreign taxes paid in the computation of their taxable income. In effect, foreign taxes – income taxes and other types of taxes – are treated as costs or current expenses of doing business or earning income in the foreign jurisdiction. As noted above, the deduction method is the least generous method of granting relief from international double taxation.

The deduction method was used by a number of countries in the formative years of their tax systems when worldwide tax rates were low, and at that time it was an acceptable approach. As tax rates increased in the post-World War II period, however,

most countries adopted either the exemption method or the credit method as the basic method for relieving international double taxation. The OECD and UN Model Treaties authorize only the exemption method and credit method as methods for granting double-tax relief.

The deduction method has not disappeared. Several countries that have adopted the credit method have retained the deduction method as an optional form of relief and as a way of dealing with foreign taxes that, for some reason, do not qualify for the foreign tax credit. In addition, some countries use the deduction method for taxes paid with respect to income derived from foreign portfolio investments.

In effect, countries use the deduction method whenever they tax residents on the net amount of the dividends they receive from a foreign corporation, assuming that the foreign corporation has paid some foreign income tax and a foreign tax credit is not allowed with respect to that tax. For example, assume that FCo, a foreign corporation, earns 100 of foreign income and pays foreign income tax of 20. FCo pays its remaining after-tax income of 80 as dividends to its shareholders, including a dividend of 20 to R, a resident of Country A who owns 25 percent of the shares of FCo. On these facts, R has earned 25 of foreign source income through FCo on which foreign income tax of 5 (25 percent × 20) is paid. If Country A taxes R on income of 20, it is in effect allowing R a deduction for the 5 of income tax that was paid by FCo. A country that requires the associated tax to be added to net dividends is said to "**gross up**" the dividends to approximate the before-tax income out of which the dividends were paid. The purpose of a gross-up rule is to provide equivalent treatment to taxpayers earning foreign income directly and taxpayers earning such income indirectly through a foreign corporation. See the discussion of the **indirect foreign tax credit** in section 4.3.3.3 below.

The effect of the deduction method is that residents earning foreign source income and paying foreign income taxes on that income are taxable at a higher combined tax rate than the rate applied to domestic source income. As a result, the deduction method creates a bias in favor of domestic investment over foreign investment whenever the foreign investment is likely to be subject to foreign income tax. Thus, the deduction method is not neutral with respect to the allocation of resources between countries. This treatment may be justified from the viewpoint of national self-interest: not only is domestic investment encouraged, but also residents with equal net worldwide income are treated similarly in that they will pay the same amount of domestic tax. Of course, from the perspective of the total (combined domestic and foreign) tax burden on a taxpayer's worldwide income, the deduction method does not achieve equal treatment of residents. Although residents with equal net worldwide income will pay the same domestic tax, they may pay widely differing amounts of foreign tax.

4.3.2 Exemption Method

Under the exemption method, the country of residence taxes its residents on their domestic source income and exempts them from domestic tax on some or all of their

foreign source income. In effect, the country of residence gives up its right to tax foreign source income, which consequently is taxable exclusively by the source country. The exemption method completely eliminates residence-source international double taxation because only one jurisdiction, the source country, imposes tax on the income.

Some countries – Hong Kong is a prominent example – have adopted the exemption method with respect to most or all foreign source income earned by their residents. In effect, these countries tax only income from domestic sources. For this reason, they are often said to tax on a territorial basis rather than a worldwide basis. For most countries using the exemption method, however, the exemption of foreign source income is limited to certain types of income, most commonly business income earned in foreign countries and dividends from foreign affiliates. Further, the exemption method is sometimes restricted to income that has been subject to tax, or subject to a minimum rate of tax, by the foreign country.

Although foreign source income may be exempt from residence country tax by countries using the exemption method, the income may be taken into account in determining the rate of tax applicable to the taxpayer's other taxable income. This practice is referred to as "exemption with progression." In such systems, the foreign source income is included in income for the limited purpose of determining a taxpayer's average tax rate as if the foreign income were taxable; this average rate is then used to compute the actual tax due on the taxpayer's other (non-exempt) income. Several countries, including Belgium, Finland, Germany, and the Netherlands, use the exemption with progression method.

Example

Assume that Country A levies tax at a rate of 20 percent on the first 10,000 of income and 40 percent on income in excess of 10,000. T, a taxpayer resident in Country A, has 10,000 of domestic source income from Country A and 10,000 of exempt foreign source income. T would pay tax of 2,000 (20 percent of 10,000) under a regular exemption system. Under an exemption with progression system, T must determine the average tax rate that would apply if his entire income of 20,000 were domestic source income. In this example, the average rate would be 30 percent ((10,000 × 0.20 + 10,000 × 0.40) divided by 20,000). The tax payable to Country A would then be determined by applying the 30 percent average rate to the domestic source income of 10,000, resulting in tax payable of 3,000.

The exemption method is relatively simple for the tax authorities to administer and is effective in eliminating international double taxation. The exemption with progression system is more complex because it requires the tax authorities to obtain information about the amount of foreign source income earned by resident taxpayers.

Although the exemption method is widely used and is sanctioned by both the OECD and UN Model Treaties (see Article 23A of both treaties), it is inconsistent with the tax policy objectives of fairness and economic efficiency. To the extent that foreign taxes are lower than domestic taxes, resident taxpayers with exempt foreign source income are treated more favorably than other residents. Moreover, an exemption system encourages resident taxpayers to invest abroad in countries with lower tax rates, especially in tax havens, and encourages them to divert domestic source income

to such countries. For example, a taxpayer residing in an exemption country who earns interest on funds invested in that country has a strong incentive to move the funds to a foreign country that imposes low or no taxes on interest income.

Because of these deficiencies, as noted above, the application of the exemption method for relieving double taxation to all foreign source income, which is equivalent to taxing on a territorial basis, is difficult to justify and is used by only a few countries. The exemption method can be justified if it is used as a convenient and simple proxy for the credit method or is limited to certain types of income. For example, a country might exempt resident taxpayers on income derived from foreign countries that impose tax at rates and under conditions that are roughly comparable to its own rates and conditions. If such an exemption system is properly enforced, the results are similar to those obtained under a credit system because, in such circumstances, a country using the credit method would collect little or no tax with respect to any foreign source income that is subject to foreign tax comparable to the residence country's tax. This point is illustrated in the following example.

Example

ACo is resident in Country A, which levies income tax at a rate of 40 percent. ACo earns income of 1,000 in each of Country B and Country C, which levy tax at rates of 40 and 50 percent respectively. Country A has a foreign tax credit system to relieve international double taxation. Consequently, the credits for taxes paid to Countries B and C, 400 and 500 respectively, will completely offset Country A's tax of 800 on ACo's total foreign source income of 2,000. Country A will collect tax from ACo after allowing the credit for foreign taxes only if ACo's effective foreign tax rate is less than the effective tax rate of Country A.

Of course, in the example above, the effective foreign tax rate may be lower than the Country A rate even if Country B and Country C generally impose substantial taxes on foreign corporations. For example, one or both countries may offer some special tax incentives or their tax laws may contain some loopholes that foreign corporations are able to exploit. In such circumstances, Country A might collect some tax revenue from ACo in respect of its foreign source income.

Several countries use the exemption method for active business income earned by resident corporations through a foreign branch or permanent establishment. Several countries also exempt certain dividends received from foreign corporations in which resident corporations have a minimum ownership interest, usually 5 or 10 percent. This exemption for dividends is often referred to as a **participation exemption** and is discussed in more detail in section 4.3.3.1 below.

The alleged virtue of the exemption method for relieving international double taxation is its simplicity: it minimizes compliance costs for taxpayers and administrative costs for tax authorities. However, for an exemption system to operate effectively, a country must be able to ensure that the exemption is limited to foreign source income that is subject to foreign tax comparable to domestic tax. Thus, an effective exemption system requires vigorous source-of-income and expense rules. It also requires anti-avoidance rules to prevent low-taxed foreign source income from qualifying for exemption. Finally, it requires expense allocation rules or anti-avoidance rules to

prevent taxpayers from deducting expenses incurred to earn exempt foreign source income against their domestic income.

One often-overlooked weakness of an exemption system is its likely impact on the shifting of tax burdens from an income earner to the payer in some circumstances. Assume, for example, that Country A, which has a corporate tax rate of 50 percent, provides an exemption for foreign source income. Country B imposes a withholding tax of 25 percent on interest payments made to nonresidents. ACo, a resident of Country A, makes a loan of 100,000 to BCo, a resident of Country B. If ACo can earn 10,000 of interest free of tax by loaning money to a resident of Country C instead of BCo, ACo is likely to demand that it receive annual payments of 10,000, net of Country B's withholding tax from BCo. Therefore, BCo must gross up its payments to ACo so that ACo ends up with 10,000 after Country B's 25 percent withholding tax. The effect of this arrangement is that the burden of the withholding tax of 2,500 imposed by Country B on the payment to ACo is borne by BCo. This economic effect would be avoided if Country A used the credit method. In that case, ACo would pay taxes of 5,000 wherever it earned the 10,000 of interest income. ACo would have no leverage to shift Country B's withholding tax to BCo because it would have no opportunity for earning 10,000 free of tax and Country B's withholding tax would be creditable against ACo's tax payable to Country A.

4.3.2.1 Participation Exemption

Most foreign direct investment takes the form of equity or share investments in foreign or nonresident corporations. Special considerations apply to the relief of international double taxation with respect to dividends from foreign corporations and capital gains from the disposition of shares of foreign corporations. This section discusses the exemption of dividends and capital gains with respect to substantial participations in foreign corporations. The indirect or underlying foreign tax credit for dividends from foreign corporations is discussed in section 4.3.3.3 below. The participation exemption and the indirect credit are compared in section 4.3.4.

Several countries use the exemption method to eliminate the double taxation of dividends from foreign corporations. The exemption method has been the traditional method used by European countries; however, in recent years Australia, Japan, and the United Kingdom have also adopted participation exemptions. The United States (US) has been discussing the possible adoption of an exemption for dividends for many years, but has not yet done so.

There are 3 key elements in the design of a participation exemption:

- the level of share ownership necessary to qualify for the exemption;
- the nature of the income earned by the foreign corporation out of which the dividends are paid; and
- the amount of foreign tax on the income of the foreign corporation.

These same three elements are also important in the design of an indirect foreign tax credit, as discussed in section 4.3.3.3.

The participation exemption is limited to dividends received by a resident corporation from a foreign corporation in which the resident corporation has a substantial ownership interest or participation. The level of share ownership required varies from 5 percent (e.g., in the Netherlands) to 25 percent (e.g., in Japan) and in the Parent-Subsidiary Directive in the EU. Many countries use a 10 percent ownership threshold. The ownership threshold can be based on voting shares, the value of shares (or both votes and value) or all the shares of the foreign corporation.

In theory, an exemption for dividends should be limited to dividends out of the active business income earned by a foreign corporation. Dividends out of passive investment income should not qualify for exemption; otherwise, resident corporations would have an incentive to divert passive income to their foreign subsidiaries in order to reduce residence country tax. For example, assume that ACo, a company resident in Country A, has funds available for investment that could earn passive income of 1 million. If ACo earns the income by investing in Country A, it will pay tax to Country A of 40 percent. However, if ACo uses the funds to acquire shares in its wholly owned subsidiary, BCo, resident in Country B, which taxes at a rate of only 10 percent, and BCo earns passive income of 1 million, BCo will pay tax to Country B of 100,000. BCo can then distribute its after-tax profits of 900,000 to ACo. Assuming that Country A exempts the dividend, this simple tax planning would result in substantial tax savings for ACo.

Therefore, some countries limit the exemption to dividends out of active business income of foreign affiliates. Such an approach imposes significant compliance obligations on taxpayers to keep track of the type of income earned by their foreign affiliates and requires rules to determine the type of income from which dividends are considered to be paid. As a consequence of these problems, some countries have abandoned any attempt to limit their participation exemptions to dividends paid out of active business income of foreign affiliates of resident corporations, and instead rely on CFC rules or other anti-avoidance rule to prevent the abuse of the participation exemption. For example, under CFC rules, any passive income earned by a controlled foreign affiliate of a resident corporation is taxable to the resident corporation when earned by the controlled foreign affiliate without waiting for the income to be distributed in the form of a dividend. If the passive income is taxable to the resident parent corporation when earned, any subsequent dividend out of that income can be exempt from tax. CFC rules are discussed in Chapter 7, section 7.3.

As noted above, if the income of a foreign affiliate in which a resident corporation has a substantial participation is subject to foreign tax at a rate that, when combined with any withholding tax on dividends, approximates the tax rate imposed by the residence country, the residence country will not collect any tax on dividends from foreign affiliates in that country even if it uses the credit method. Therefore, from a theoretical tax policy perspective, a participation exemption can be justified as a proxy for a foreign tax credit if the exemption is limited to dividends out of income that is subject to foreign tax (corporation tax and dividend withholding tax) at a rate that is comparable to the residence country's corporate tax rate.

Some countries have limited their participation exemptions to dividends from foreign affiliates established in listed comparable-tax countries or to countries with

which they have concluded bilateral tax treaties that provide an exemption for dividends. In the interests of simplicity, other countries have abandoned any attempt to limit their participation exemptions to dividends that are paid out of income that has been subject to foreign tax comparable to residence country tax. In these countries, the participation exemption is available even for dividends from foreign affiliates in low-tax countries. Most of these countries rely on other rules, such as CFC rules, to prevent abuses of the participation exemption. As noted above, if the income of a CFC is taxable to its resident parent corporation when earned, any subsequent dividends out of that income can be exempt from residence country tax.

Some countries with a participation exemption for dividends from foreign affiliates also extend the exemption to capital gains on the disposition of the shares of those foreign affiliates. The rationale for extending the participation exemption to capital gains is that, from an economic and commercial perspective, dividends are often a substitute for capital gains with respect to substantial participations. Thus, if dividends from a foreign affiliate are exempt from tax by the country in which the shareholder corporation is resident but capital gains on the sale of the shares of a foreign affiliate are not exempt, the shareholder corporation can reduce the capital gain from the sale of the shares of a foreign affiliate by requiring it to pay exempt dividends before the sale.

For example, assume that ACo, resident in Country A, owns all of the shares of BCo, resident in Country B. Country A has a participation exemption for dividends from foreign corporations in which resident corporations own at least 10 percent of the shares (by votes and value). However, Country A imposes a tax of 20 percent on capital gains, including capital gains from the disposal of shares of foreign corporations. ACo is contemplating a sale of the shares of BCo to an arm's length purchaser and expects to make a capital gain of 10 million (proceeds of sale of 14 million less the cost of the shares (4 million)). The gain would be subject to tax by Country A of 20 percent of 10 million, or 2 million. If BCo pays a dividend of 10 million to ACo before the sale, the dividend will reduce the value of the shares, the proceeds of sale and the capital gain. However, the dividend may be subject to withholding tax by Country B. If so, the payment of dividends to reduce the capital gain would be beneficial only to the extent that the source country's withholding tax is less that the residence country's tax on the capital gain.

4.3.3 Credit Method

Under the credit method, foreign taxes paid by a resident taxpayer on foreign source income generally reduce domestic taxes payable on that income by the amount of the foreign tax. For example, if P pays a foreign tax of 10 on some foreign source income and would otherwise be subject to domestic tax of 40 on that income, the foreign tax credit reduces the domestic tax payable from 40 to 30. Consequently, the credit method completely eliminates international double taxation of the residence-source type. Under the credit method, foreign source income is subject to domestic tax whenever the foreign tax paid is less than the domestic tax payable. In such circumstances, the

net domestic tax is an amount equal to the foreign source income multiplied by the difference between the two tax rates. In effect, assuming that the domestic tax rate is lower than the foreign tax rate, the foreign taxes are "topped up" by domestic taxes so that the combined domestic and foreign tax rate on the foreign source income is equal to the domestic tax rate.

Invariably, credit countries do not refund foreign taxes paid by their residents on foreign source income in excess of the domestic tax on that income; see, for example, Article 23B of the OECD and UN Model Treaties. Similarly, countries with foreign tax credit systems do not generally allow excess foreign taxes to offset taxes imposed on domestic income. In other words, the credit for foreign taxes paid is usually limited to the amount of the domestic tax payable on the foreign source income. Various limitation rules, sometimes quite complex in application, as discussed below, are used to prevent what are perceived to be inappropriate uses of foreign tax credits. As a result of these limitations on the credit, foreign income is typically taxed at the foreign tax rate whenever the foreign rate is higher than the domestic rate. In summary, under the credit method, foreign source income earned by residents is generally taxed at the higher of the domestic and foreign tax rates.

4.3.3.1 General Rules

The credit method avoids the shortcomings of the deduction method described in section 4.3.1: resident taxpayers are treated equally from the perspective of the total domestic and foreign tax burden on their foreign source income, except when foreign taxes exceed domestic taxes. Moreover, subject to the same exception, the credit method is neutral with respect to a resident taxpayer's decision to invest domestically or abroad. These points are illustrated by the following example.

X and Y, who are both residents of Country A, each earn 100 of foreign source income. The foreign tax on such income is nil for X and 40 for Y. If both X and Y are subject to tax by Country A at a rate of 50 percent, X will pay 50 and Y will pay 10 of tax to Country A. In both cases, the combined domestic and foreign tax paid will be 50. If the foreign tax paid by Y is 60, however, the combined domestic and foreign tax rate on Y would be 60 percent because Country A would not provide relief for 10 of foreign taxes paid (60) in excess of domestic taxes (50) on the foreign source income. As a result, Y would pay tax of 60 and X would pay tax of 50.

Many countries allow foreign income taxes that cannot be credited in the current year (excess foreign tax credits) to be carried forward and credited against domestic taxes in future years. The carry forward period varies from country to country. The limitations on the credit apply to the deduction of these excess foreign tax credits in future years. Assume, for example, that R is resident in Country A, which imposes tax at a rate of 30 percent. In year 1, R earns foreign income of 100 and pays foreign tax of 50. The foreign tax is allowed as a credit against the Country A tax to the extent of 30, thereby eliminating completely the tax payable to Country A. To the extent that the foreign tax exceeds the Country A tax (20), the foreign tax is not creditable, and R has an excess credit of 20. In year 2, assume that R earns foreign income of 100 and pays

foreign tax of 25. R might be allowed a credit of 30 – the current foreign tax of 25 plus 5 of the excess credit carried forward from year 1 for use in future years. The amount of the excess credit from year 1 that is available for carry forward to year 3 and subsequent years would be reduced from 20 to 15.

On tax policy grounds, the credit method is recognized by many tax commentators to be theoretically the best method for eliminating international double taxation. The credit method, however, is not free from difficulties. Most importantly, the operation of a foreign tax credit system can be complex from the perspectives of both the government and taxpayers. Among the difficult questions that must be resolved are the following:

- What foreign taxes are creditable?
- How should the limitations on the credit be calculated? On a source-by-source, an item-by-item, a country-by-country, or an overall basis, with various special rules applicable to certain types of income? Or some combination of these methods?
- What rules should be adopted for determining the source of income and deductions?

Detailed, technical, and highly complicated legislative provisions are needed to resolve these and other matters if the credit method is to operate effectively. The compliance and administrative burdens imposed on taxpayers and tax authorities as a result of these complex rules are probably both necessary and justifiable in respect of income earned in no-tax or low-tax countries – otherwise, domestic tax could be avoided by diverting domestic source income to these countries.

When resident taxpayers are subject to foreign tax on their foreign source income at a rate that is comparable to the domestic tax rate, it is questionable whether the complexity of a credit system is worthwhile. In such circumstances, a country is unlikely to collect a significant amount of domestic tax from those taxpayers with respect to their foreign source income after allowing them a credit for foreign taxes. A foreign tax credit system used by one country may encourage other countries to increase their taxes on income earned by residents of that country to the level of tax in that country (so-called **"soak-up" taxes**). Such a tax increase would not affect the after-tax return to nonresident investors and therefore would not discourage investment from abroad. It would, however, result in a shift of tax revenues from the country with the credit system to the country in which the income is earned. For example, assume that Country A imposes tax at a rate of 40 percent and uses a foreign tax credit system, and that residents of Country A have substantial investments in Country B. If Country B imposes tax on the income earned by residents of Country A at 25 percent, the residents of Country A will be subject to tax by Country A on the income earned in Country B of 15 (40 – foreign tax credit of 25) and total taxes on the income of 40 (25 to Country B and 15 to Country A). However, if Country B imposes tax at 40 percent on the income earned by the residents of Country A, those residents will still be subject to total tax on the income of 40, but the entire tax will be paid to Country B.

A country is most likely to impose a discriminatory tax on residents of credit countries when the overwhelming amount of foreign investment in the country is owned by residents of a few foreign countries, and those foreign countries have approximately equivalent tax rates. Some countries include provisions in their foreign tax credit rules to prevent the soak-up taxes from qualifying as creditable foreign taxes.

Many countries use the credit method to eliminate international double taxation with respect to at least certain taxpayers and types of foreign source income. Some countries grant a credit for foreign taxes unilaterally; others grant a credit only pursuant to their bilateral tax treaties. Most credit countries grant the credit both unilaterally and by treaty. Still others have extended their foreign tax credit mechanisms to encompass "**tax sparing**". Tax sparing is discussed in section 4.5 below.

4.3.3.2 Types of Limitations

As noted above, countries that use the credit method limit the credit for foreign taxes to the amount of domestic tax on the foreign source income. For this purpose, countries use a variety of limitations.

Under an overall or worldwide limitation, foreign taxes paid to all foreign countries are aggregated; in effect, the credit is limited to the lesser of the aggregate of foreign taxes paid and the domestic tax payable on the total amount of the taxpayer's foreign source income. This method permits the averaging of high foreign taxes paid to some countries with low foreign taxes paid to other countries.

Under a country-by-country or per-country limitation, the credit is limited to the lesser of the taxes paid to a particular foreign country and the domestic tax payable on the taxpayer's income from that particular country. This method prevents the averaging of high and low foreign taxes paid to different countries, but it permits the averaging of high and low rates of foreign tax paid to a particular country on different types of income.

Under an item-by-item limitation, the credit is limited to the lesser of the foreign tax paid on each particular item of income and the domestic tax payable on that item of income. This method prevents averaging and is probably the best method from a theoretical perspective, although few countries use it in practice. In this context, an "item" of income is some defined category of income, such as interest income or shipping income. In principle, a country might define an item of income as any category of income subject to a special tax regime in a foreign country. For example, a country might treat business income and interest income arising in a foreign country as separate items of income for purposes of imposing a limitation on its foreign tax credit, especially if foreign countries tax interest income derived by nonresidents at preferential (low) rates.

The results of the overall, per-country, and item-by-item limitations on the foreign tax credit are compared in the following example. ACo, a resident of Country A, earns foreign source income and pays foreign taxes on such income, as shown in the following table.

Table 4.2 Example: Facts

	Foreign Income	*Foreign Tax*
Business income from Country X	100,000	45,000
Dividends from Country X	20,000	1,000
Business income from Country Y	50,000	10,000
Interest from Country Z	10,000	1,500

The corporate tax rate in Country A is 30 percent. ACo earns 200,000 domestic source income from its business carried on in Country A. If there is no limitation on the foreign tax credit, the amount of tax payable to Country A would be:

Example: No Limitation

Total income	380,000
Tax before credit (30%)	114,000
Foreign tax credit	57,500
Total tax	56,500

Therefore, the total tax payable would be 114,000 (foreign tax of 57,500 and Country A tax of 56,500). If Country A uses an overall, per-country, or item-by-item limitation, the tax payable would be as follows.

Table 4.3 Example: Overall Limitation

Overall Limitation	
Country A tax before credit	114,000
Credit:	
Lesser of:	
(1) Foreign tax of 57,500	
(2) Country A tax on foreign income (180,000 × 30% = 54,000)	54,000
Country A tax after credit	60,000
Total tax (57,500 + 60,000)	117,500

Example: Per-Country Limitation

Per-Country Limitation	
Country A tax before credit	114,000
Credit:	
(a) Country X	
Lesser of:	
(1) Foreign tax of 46,000	

(2) Country A tax on Country X income (120,000 × 30% = 36,000)	36,000
(b) Country Y	
Lesser of:	
(1) Foreign tax of 10,000	
(2) Country A tax on Country Y income (50,000 × 30% = 15,000)	10,000
(c) Country Z	
Lesser of:	
(1) Foreign tax of 1,500	
(2) Country A tax on Country Z income (10,000 × 30% = 3,000)	1,500
Total creditable taxes	47,500
Country A tax after credit	66,500
Total tax (66,500 + 57,500)	124,000

Example: Item-by-Item Limitation

Item-by-Item Limitation	
Country A tax before credit	114,000
Credit:	
(a) Country X	
(i) business income	
lesser of:	
(1) Foreign tax of 45,000	
(2) Country A tax on business income (100,000 × 30% = 30,000)	30,000
(ii) dividends	
lesser of:	
(1) Foreign tax of 1,000	
(2) Country A tax on dividends (20,000 × 30% = 6,000)	1,000
(b) Country Y	
lesser of:	
(1) Foreign tax of 10,000	
(2) Country A tax on business income (50,000 × 30% = 15,000)	10,000
(c) Country Z	
lesser of:	
(1) Foreign tax of 1,500	
(2) Country A tax on interest (10,000 × 30% = 3,000)	1,500
Total creditable taxes	42,500

Country A tax after credit	71,500
Total tax (71,500 + 57,500)	129,000

The three methods for limiting the foreign tax credit are not mutually exclusive. For example, a country could use an overall limitation as the basic method and also use the item-by-item method for certain types of income such as active business income and passive investment income. Several countries use this type of hybrid method, which is sometimes referred to as the **separate-baskets approach**.

4.3.3.3 Indirect or Underlying Credit

Some countries, such as the US, provide what is often referred to as an "indirect" or "underlying" foreign tax credit. The indirect credit is a credit granted to a resident corporation for the foreign income taxes paid by a foreign affiliated company when the resident corporation receives a dividend distribution from its foreign affiliate. The amount allowable as a credit is the amount of the underlying foreign tax paid by the foreign affiliate on the income out of which the dividend was paid. Ordinarily, a foreign tax credit is allowable only for foreign income taxes that a resident taxpayer pays directly. In effect, the indirect credit rules ignore the separate corporate existence of the resident and foreign corporations for the limited purpose of allowing the credit. To claim a credit for taxes paid by a foreign affiliate, the domestic corporation must usually own a substantial interest, varying from 5 percent to 25 percent, in the share capital of the foreign corporation.

The basic operation of an indirect foreign tax credit is illustrated in the following example. Assume that ACo, resident in Country A, has a wholly owned subsidiary BCo, resident in Country B. BCo's income for the year is 800, and it pays tax to Country B at a rate of 30 percent, or 240, on its income. BCo distributes all its after-tax profits of 560 (800 – 240) to ACo as a dividend. ACo is taxable in Country A on 800 – the dividend of 560 and the underlying tax of 240 (often referred to as the "gross-up amount"). Assuming that Country A levies tax at a rate of 40 percent and there is no limitation on the foreign tax credit, the tax payable to Country A would be 80 (320 minus a foreign tax credit of 240 for the foreign taxes paid by BCo on the income out of which the dividend was paid).

Table 4.4 Example: Indirect or Underlying Foreign Tax Credit

BCo's income	800
Country B tax	240
After-tax profit	560
Dividend paid	560
ACo's income:	
Dividend received from BCo	560
Gross-up amount	240

Total	800
Country A tax before credit (40%)	320
Credit for Country B tax paid by BCo	240
Net Country A tax	80

If the dividend received by ACo in the above example is subject to withholding tax by Country B, the withholding tax would also usually be creditable against ACo's tax payable to Country A, subject to any applicable limitation rule. The credit for withholding tax is a direct foreign tax credit, not an indirect credit, because ACo is treated as paying the withholding tax.

The credit method may have the effect of discouraging domestic corporations that have earned profits abroad through foreign affiliates from repatriating these profits as dividend distributions. Assume that ACo, resident in Country A, has a wholly owned affiliate, FCo, resident in Country F. The tax rate in Country A is 35 percent and the rate in Country F is 10 percent. FCo earns profits in Country F of 100 and pays tax to Country F of 10. If FCo's after-tax profits are repatriated to ACo as a dividend of 90, ACo will get a foreign tax credit of 10 for the underlying foreign tax paid by FCo, but it will be required to pay a net tax to Country A of 25, as shown below.

Table 4.5 Example: Effects of the Credit Method

Dividend received from ACo	90
Gross-up amount	10
Income of ACo	100
Country A tax before credit (35%)	35
Indirect foreign tax credit for taxes paid by FCo	10
Country A tax	25

By retaining the profits in FCo, ACo can defer indefinitely the potential Country A tax of 25. This type of tax planning strategy has been adopted by several US multinationals and has been sharply criticized by some US politicians.

To avoid creating a bias against the repatriation of profits, a credit country could tax the income of foreign affiliates of resident corporations on an accrual basis (i.e., as the income is earned by the foreign affiliates). Accrual taxation would eliminate the **deferral** of residence country tax on the foreign source income earned by residents through foreign affiliates. Proposals for a comprehensive accrual system have surfaced from time to time, but have not yet been adopted in any country, although accrual taxation is used in some circumstances. Under the **controlled foreign corporation rules** and the **foreign investment fund rules** described in sections 7.3 and 7.4, some countries impose domestic taxes currently on certain income earned by foreign affiliates and foreign funds in what are perceived to be abusive situations.

The rules designed to govern the indirect foreign tax credit are often the most complex part of a foreign tax credit system. The indirect credit is available only when a resident corporation receives a dividend from a foreign affiliate. The amount

allowable as a credit is the amount of foreign income tax properly attributable to the dividend. Difficult timing and income measurement issues must be resolved for this purpose. For example, the resident corporation must determine the profits of the foreign affiliate out of which the dividend was paid and the foreign tax attributable to those profits. Those profits may have been earned over many years in the past and would usually have been computed in a foreign currency under tax accounting rules that may differ significantly from the tax accounting rules applicable to the resident corporation. When these rules are combined with rules for limiting the foreign tax credit discussed in section 4.3.3.2 above, the level of complexity causes serious compliance and administrative problems. This complexity has led several countries to adopt exemption systems for dividends from foreign affiliates.

4.3.4 Comparison of the Exemption and Credit Methods

The debate about whether the exemption method or the credit method is better for relieving international double taxation is often vigorous and emotional. Few countries have either a pure exemption system or a pure credit system. Costa Rica, Hong Kong and Panama are examples of jurisdictions that tax on a territorial basis; they tax only income earned or having its source in their territory and generally exempt all foreign source income from tax. For most countries using the exemption method, however, the exemption of foreign source income is often restricted to certain active business income earned by resident corporations and dividends from foreign affiliates. Thus, a corporation is often exempt only on its active business income derived from foreign sources and dividends received out of the active business income of its foreign affiliates. An exemption is not generally available for investment income because such an exemption would make it easy for resident taxpayers to avoid paying taxes on their investment income by shifting the source of domestic investment income to a foreign country.

With respect to business income, an analysis of the exemption and credit methods indicates, first, that the two methods raise essentially the same structural issues, and second, that the two methods are reasonably comparable if designed properly. The following material compares an exemption for dividends received out of active business income of foreign affiliates and an indirect credit for the underlying foreign taxes paid by foreign affiliates on active business income.

The first point is that the results of these two methods for relieving international double taxation are the same if the underlying foreign taxes paid by the foreign affiliate, plus any withholding taxes on the dividends, are at least equal to the domestic taxes on the dividends. Under the exemption method, the dividends are exempt from domestic tax, so the total tax is the sum of the underlying foreign taxes paid by the foreign affiliate on the income out of which the dividend is paid and any foreign withholding taxes on the dividend. Under the indirect credit method, the underlying foreign taxes and the foreign withholding taxes are creditable against the domestic tax on the dividend. Therefore, if the sum of those foreign taxes equals or exceeds the domestic tax on the dividend, no domestic tax is payable. This result is illustrated in the following example.

Assume that Parentco, a company resident in Country A, has a wholly owned subsidiary, Forco, resident and carrying on business in Country B. Country A imposes tax on corporate profits at a rate of 35 percent. Country B imposes tax on corporate profits at a rate of 30 percent. Forco earns profits of 100, pays tax to Country B of 30, and distributes its entire after-tax income of 70 to Parentco as a dividend. The tax results, if Country A uses a participation exemption or an indirect credit system for relieving international double taxation of dividends, are shown in the table below.

Table 4.6 Comparison of Credit and Exemption Methods

	Credit	*Exemption*
Forco		
Income of foreign subsidiary	100	100
Foreign tax (30%)	30	30
Dividend to parent	70	70
Withholding tax (10%)	7	7
Parentco		
Dividend received	70	70
Gross-up amount	30	
Taxable income	100	0
Domestic tax before credit	35	–
Foreign tax credit	37	–
Net domestic tax	0	0
Total tax	37	37

Even if the sum of the foreign corporate tax and the dividend withholding tax is less than the domestic tax, remember that the domestic tax payable by Parentco is deferred until dividends are received. The longer the payment of dividends is deferred, the lower the present value of the domestic taxes on the dividends, assuming that the foreign affiliate can earn a higher after-tax rate of return on the funds than its parent corporation.

The usual justification for a participation exemption is simplicity: the reduction of the costs of administration and compliance for tax officials and taxpayers. However, the benefits of simplification are often overstated or are achieved only by sacrificing the integrity of the exemption.

If the participation exemption is intended to be a proxy for the indirect credit, it should be designed to ensure that the exemption is restricted to foreign source income that is subject to foreign tax rates that are comparable to domestic tax rates. A properly designed exemption system for dividends requires complicated rules to protect its integrity. Many of these rules are strikingly similar to the rules with respect to an indirect foreign tax credit. For example, both systems require rules dealing with:

- the resident taxpayers qualifying for the exemption or credit; (usually, the entitlement to the exemption or credit is limited to foreign affiliates in which