CHAPTER 5

Taxation of Nonresidents

5.1 INTRODUCTION

As noted in Chapter 2, most countries tax their residents on their worldwide income and nonresidents on their domestic source income (i.e., income earned or derived in a country's territory). A few countries impose tax exclusively on domestic source income (territorial taxation) irrespective of whether the income is derived by a resident or a nonresident. Thus, it is fair to say that all countries, other than pure tax havens, tax the income earned or derived in their territory by nonresidents. For countries that tax on a worldwide basis, it is necessary to have rules that distinguish between residents and nonresidents because nonresidents are taxable only on their domestic source income, not on their worldwide income. The rules for determining whether a person is a resident of a country for income tax purposes are discussed in Chapter 2, section 2.2.

As discussed in Chapters 2 and 3, the international consensus is that countries are entitled to tax any income that arises or has its source in their territory. The rules for determining the source of income are dealt with in Chapter 2, section 2.3. A country's right to tax domestic source income takes priority over the right of another country to tax that income based on the residence of the person deriving the income. For this reason, the residence country has an obligation to relieve international double taxation in recognition of the source country's prior right to tax.

This chapter examines the major issues involved in taxing nonresidents on their domestic source income. The chapter begins with a brief discussion of the policy justification for taxing nonresidents and then deals with practical issues such as threshold requirements, the taxation of business profits and investment income of nonresidents, and the collection of tax from nonresidents.

It is convenient for conceptual purposes to divide the taxation of nonresidents into the following stages:

- A country must determine what type of connection (nexus) a nonresident must have to the country (activities in the country, the ownership of property

in the country, physical presence in the country, etc.) in order for the country to be able to exercise its jurisdiction to tax.
- Once a country has decided that it has jurisdiction to tax, it must decide whether it should exercise that jurisdiction to tax only if the nonresident meets some minimum threshold such as a permanent establishment or fixed base.
- If the threshold is met or the country decides that a threshold is unnecessary, a country must have rules to determine what amounts derived by nonresidents are subject to tax; these rules are usually referred to as source rules.
- Rules are necessary to compute the nonresident's income and tax payable.
- Finally, rules are necessary with respect to the collection of tax from nonresidents.

These stages are intimately connected and often overlap. For example, if a country decides to tax any interest or dividends paid by a resident to a nonresident, the source of the income as represented by the residence of the payer is the connection that gives the country the jurisdiction to tax; accordingly, that country has rejected the necessity for any threshold requirement. Similarly, transfer pricing rules can be viewed as source rules or as computational rules. These stages are set out here to assist in the analysis of the taxation of nonresidents; they do not attempt to describe the ways in which countries actually tax nonresidents.

The distinction between business profits and investment income is particularly important with respect to the taxation of nonresidents. Business income is typically taxed on a net basis at the same rates applicable to resident taxpayers, so that individuals earning business income in another country are often subject to tax at progressive rates. In contrast, investment income is typically taxed at a flat rate on the gross amount; moreover, the tax is usually imposed by way of a withholding tax (i.e., there is an obligation on the resident person paying the amount to the nonresident to withhold the amount of the tax from the payment to the nonresident and to remit the tax to the tax authorities).

5.2 TAX POLICY CONSIDERATIONS IN TAXING NONRESIDENTS

It may be recalled from Chapter 3, section 3.2 that the tax policy justifications for taxing residents on their worldwide income are equity and neutrality. It is difficult to justify taxing nonresidents on the basis of equity because the source country does not have complete information about the nonresident's tax situation; for example, income earned in the source country may be offset by losses incurred in other countries. It is generally impossible for a country to determine whether residents and nonresidents are similarly situated for tax purposes except in situations where all or almost all of a nonresident's income is derived from one country.

In general, however, it is reasonable to say that, to the extent possible, nonresidents should not be treated better or worse than residents in similar situations. The

taxation of nonresidents on their domestic source income can be justified on the basis that nonresidents derive benefits from the source country; for example, nonresidents doing business in a country take advantage of the country's infrastructure and its legal system in the same way as residents. It can also be argued that, even if a nonresident simply sells goods in a country, the nonresident is benefiting from the market provided by that country and that benefit is sufficient to justify taxation.

The principle that nonresidents deriving income from a country should not be treated less favorably than residents of that country – the **nondiscrimination principle** – is an important principle that most countries follow, at least in part. Although it may be tempting for a country to tax nonresidents more harshly than residents – after all, nonresidents do not vote – the likely response of other countries would be to do the same, thus putting the first country's residents at a disadvantage. In practice, there is surprisingly little discrimination against nonresidents in the tax systems of most countries. Many countries do, however, discriminate in favor of nonresidents in certain circumstances by providing them with tax holidays and other tax incentives in order to attract foreign investment. Discrimination in favor of nonresidents is not considered to be offensive, although it is widely criticized by tax policy commentators. The nondiscrimination principle is recognized in Article 24 of both the OECD and the UN Model Treaties. The **nondiscrimination article** in tax treaties is dealt with in Chapter 8, section 8.8.1.

From a revenue perspective, it makes obvious sense for countries to tax nonresidents. However, the need for tax revenue must be balanced against the need for foreign investment. If a country taxes nonresidents too harshly, the effect may be to discourage nonresidents from investing in the country; moreover, other countries can be expected to respond by taxing that country's residents equally harshly. Thus, countries that import and export capital and tax on a worldwide basis have interests as both residence countries and source countries that must be balanced. As residence countries, they want to minimize tax imposed by source countries on the foreign source income of their residents and to ensure that their residents are not discriminated against relative to the residents of source countries. As source countries, they want to attract foreign investment but also want to tax nonresidents as heavily as possible. These competing interests cannot all be achieved fully because of the inevitable retaliation by other countries that would result.

Another important consideration in the taxation of nonresidents is enforcement. On the one hand, it obviously makes no sense for a country to impose tax on nonresidents that cannot be enforced effectively. On the other hand, it may not make sense for a country to tax all the income derived by nonresidents that can be enforced effectively. Most countries do not follow the practice of taxing nonresidents on everything that they can tax, probably because, as noted above, they do not want other countries to do the same and they want to attract foreign investment. Nevertheless, it is probably fair to say that countries seriously consider taxing nonresidents to the maximum extent possible unless there is some good reason not to.

5.3 THRESHOLD REQUIREMENTS

Although there is no restriction on the authority of a country to tax any and all domestic source income derived by a nonresident, few countries do so – most countries tax nonresidents on certain types of income only if a minimum threshold is met. For example, many countries tax nonresidents on their business income only if the income is attributable to a PE in the country. This threshold for the taxation of business profits is also used in Article 7 of the OECD and UN Model Treaties. Even countries that do not use the PE concept in their domestic law usually tax nonresidents on their business income only if their business activities exceed some threshold; for example, in the United States nonresidents are taxable on their business income only if they are engaged in a trade or business in the United States.

There are several reasons for the establishment of a threshold requirement for the taxation of nonresidents. First, serious compliance and enforcement problems arise when nonresidents are taxable on all domestic source income. It is difficult for tax authorities to identify all nonresidents earning income from the country and to get information about that income. (Consider, for example, the difficulties in taxing a consultant who performs services in a country for a few days.) Moreover, unless a nonresident has some type of substantial and continuing presence in a country, it may be difficult or impossible for the country to collect its tax. Second, as noted in Chapter 2, section 2.3, few countries have detailed source rules; as a result, a threshold requirement can provide more certainty for nonresidents as to when they become subject to tax by a country. Third, requiring nonresidents to file tax returns and pay tax on relatively small amounts of income is likely to discourage cross-border trade and investment or result in nonresidents ignoring their tax obligations.

Threshold requirements for taxing nonresidents are provided by domestic law and tax treaties and differ depending on the type of income. Some common thresholds are described below:

- *Business profits*: The threshold provided by tax treaties is the existence of a PE in a country. In general, a PE is a fixed place of business or a dependent agent with authority to contract on behalf of the nonresident. Certain types of business profits, such as income derived by entertainers and athletes, are usually subject to a lower threshold. The UN Model Treaty uses a 183-day threshold for the taxation of income from services derived by nonresidents and has a special provision for insurance businesses.
- *Income from immovable property:* The immovable property must be located in the country.
- *Employment income:* As a general rule, the threshold is the physical presence of the employee in the country and the performance of the duties of employment in the country, although under tax treaties the source country is precluded from taxing a nonresident employee of a nonresident employer without a PE in the source country, unless the employee is physically present for more than 183 days.

- *Investment income:* Typically, there is no threshold for source country taxation of dividends, interest, and royalties under domestic law or treaties. As discussed below, the source country tax is imposed as a final withholding tax at a flat rate on the gross amount of the payment.

In general, thresholds for the taxation of nonresidents take the form of a fixed place (either a fixed place of business or immovable property) or the physical presence of the nonresident in the country (sometimes for a specified period). Thresholds based on the amount of revenue or income derived by a nonresident are rare in both domestic law and treaties.

5.4 SOURCE RULES

Once it has been determined that a country has jurisdiction to tax a nonresident and that any threshold for taxation has been met, it is necessary to have rules to determine what amounts are subject to tax and how those amounts are taxed. In general, countries tax nonresidents only on their domestic source income. As a result, source-of-income rules are necessary to determine whether a nonresident's income is derived from sources inside the territory of the country. Sometimes these source rules are explicit: for example, a country's tax law might provide that a nonresident is taxable on domestic source income and then list items or amounts that are considered to be from domestic sources. More often, however, countries simply prescribe the amounts derived by nonresidents that are subject to tax, without explicit reference to the source of those amounts. For example, a country might impose tax on dividends paid by a resident corporation to a nonresident. The source rule in this case is implicit – in effect, dividends are considered to have their source in the country in which the company paying the dividends is resident. Except in cases where the income is taxed on a gross basis, it is also necessary to determine what expenses are deductible in determining the domestic income subject to tax. Source rules are discussed in more detail in Chapter 2, section 2.3.

5.5 DOUBLE TAXATION

In situations where a resident of one country earns income sourced in another country, by international consensus the country in which the income is earned has the first right to tax the income, and the residence country has a corresponding obligation to relieve international double taxation by exempting the income from tax or providing a credit for the source country tax. Therefore, in taxing nonresidents, countries do not need to be concerned about eliminating double taxation of this type. The only type of double taxation that source countries should be concerned about is where two countries both claim that the relevant item of income has its source in their country. Accordingly, the more expansive a country's source rules are, the more likely it is that its source claims will overlap with other countries' source claims.

5.6 EXCESSIVE TAXATION OF NONRESIDENTS

Although source countries do not need to be concerned about the elimination of double taxation except in the case of overlapping source rules, they should be concerned about the excessive taxation of nonresidents. As discussed below, certain types of income are typically taxed by withholding at a flat rate on the gross amount of the payment. In these situations, there is a risk that the source country tax may be excessive relative to the net income derived by the nonresident. For example, consider a situation in which a nonresident incurs substantial expenses to earn royalties in a country. If the source country taxes the royalties at a flat rate of 30 percent without any recognition for the expenses, the nonresident may realize little, if any, after-tax profit from the transaction. If the residence country exempts foreign source royalties, it will not provide any relief for the source country tax; and even if the residence country provides a foreign tax credit, the limitation on the credit (see Chapter 4, section 4.3.3 for a discussion of the limitations on a foreign tax credit) will likely result in the taxpayer getting only partial relief for the source country tax. The overall result is that the royalties may be taxable at an effective rate that is considerably higher than the residence country tax rate. Sometimes nonresidents may be able to avoid excessive source country taxation by requiring the resident payers to effectively absorb the tax by grossing up the payments. Such excessive source country tax may be borne by residents or may discourage foreign investment.

5.7 COMPUTATION OF THE DOMESTIC SOURCE INCOME OF NONRESIDENTS

In general, the rules for computing the income of nonresidents are the same as the rules applicable to residents. Thus, the rules that determine what amounts are included in income, what deductions are allowable, and the timing of income and deductions are applicable equally to residents and nonresidents. For example, if a country allows a deduction for only a portion of a taxpayer's entertainment expenses, that rule will apply equally to nonresidents. Although in general the rules for computing the income of residents and nonresidents are the same, there are some exceptions. For example, transfer pricing rules apply to transactions between a resident and a related nonresident and not to transactions between related residents. Transfer pricing rules are discussed in Chapter 6. Similarly, thin capitalization rules are typically applicable only to interest paid by a resident corporation to nonresidents, although in a few countries the rules also apply to interest paid to tax-exempt residents. Conversely, controlled foreign corporation (CFC) rules apply only to nonresident companies that are controlled by residents of a country. Thin capitalization rules and CFC rules are dealt with in detail in Chapter 7, sections 7.2 and 7.3 respectively. It should be noted in this regard that the case law of the European Court of Justice has severely restricted the ability of an EU member country to have rules, such as thin capitalization rules or CFC rules, that apply differently to residents of that country and residents of another EU member country.

As discussed below in section 5.8, the nondiscrimination article of an applicable tax treaty requires the source country to allow nonresidents to deduct expenses in computing the profits attributable to a PE on the same basis as residents engaged in similar activities. However, where nonresidents are subject to tax on a gross withholding tax basis, no deductions are allowed. Therefore, the distinction between amounts such as business profits, which are subject to net-based taxation, and amounts such as investment income, which are subject to withholding tax, is very important. This distinction is discussed in section 5.8.1 below.

With respect to nonresident individuals, personal deductions, reliefs, allowances and credits are not customarily provided by source countries. For example, many countries provide a basic personal or family exemption from tax so that if an individual's or family's income does not exceed the minimum amount, no tax is payable. Similarly, many countries provide deductions or allowances for family members who are dependent on the taxpayer for support. These and other similar personal allowances are not generally provided by countries to nonresidents, and the typical nondiscrimination article in tax treaties does not require such allowances to be extended to nonresidents.

As mentioned above, there are no legal constraints to prevent a source country from treating nonresidents more favorably than residents. In particular, many developing countries provide nonresident investors with special tax incentives that are not available to residents.

If a country imposes a final withholding tax on the gross amount of certain payments, such as dividends, interest, and royalties, no computational rules are necessary since the gross amount is taxable. If, however, the withholding tax is imposed on an interim basis on account of a nonresident's final tax liability, rules for the computation of net income are necessary. Some South American countries impose final withholding taxes on a wide range of payments made to nonresidents. In many cases, the tax is imposed at a fixed rate on a fixed percentage of the payment rather than on the gross amount. Taxing a presumptive amount in this way represents an attempt to give relief for the expenses incurred to earn certain types of income without the necessity for either the taxpayer or the tax authorities to calculate a particular nonresident's actual income.

5.8 TAXATION OF VARIOUS TYPES OF INCOME OF NONRESIDENTS

5.8.1 Business Income

5.8.1.1 In General

Because business income earned by nonresidents is usually taxed on a net basis and investment income is taxed on a gross basis, it is important to distinguish between the two types of income. In some civil law countries, all the income earned by a legal entity is characterized as business income, and therefore it is necessary to distinguish

between business and other income only with respect to individuals. In other countries, however, both legal entities and individuals can earn various types of income. Some countries tax on a schedular basis, which means that they tax different types of income in accordance with different rules, and sometimes even at different rates. Even countries that tax on a global basis often have different rules for business income and other income. Typically, the characterization of an amount as income from business or other income arises with respect to capital gains from the disposal of property, interest, rent, and royalties.

How is the distinction between business and other income made? In many Commonwealth countries, there is a substantial body of case law concerning the distinction between capital gains and ordinary business income. This case law is usually equally applicable to nonresidents. Countries may also have statutory rules that distinguish between the two types of income. For example, some countries have rules that limit capital gains treatment to property that is held or owned for a minimum period; other gains are treated as ordinary business income. More generally, some countries may have rules that define business income.

The distinction between business and other types of income is also important for purposes of tax treaties because tax treaties deal with various types of income on a schedular basis. As a result, for example, business income, interest and capital gains are subject to different rules. The OECD and UN Model Treaties, on which most bilateral tax treaties are based, do not provide a comprehensive definition of "business". Since 2000, the OECD Model Treaty has defined business to include the performance of independent and professional services (Article 3(1)(f)) because Article 14 dealing with such activities was deleted at that time. Because of the absence of a complete definition in the treaty, it is necessary to refer to the meaning of the term "business" under the domestic law of the country applying the treaty.

Under tax treaties based on the OECD and UN Model Treaties, it is also necessary to distinguish between various types of business income. In general, under Article 7, business income derived by a resident of one country in the other country is taxable by the other country only if the business is carried on through a PE and the income is attributable to the PE. Under Article 8, however, income from international shipping and air transportation income is taxable only by the country in which the enterprise has its place of effective management. In contrast, under Article 17, business income from personal services performed by a resident of one country in the other country as an entertainer or athlete is taxable by that other country without the need for a PE in the country. In effect, under tax treaties, a PE is a threshold requirement for most business income; the rule that only profits attributable to the PE are taxable is the functional equivalent of a source rule. In the interests of accuracy, it must be noted that under Article 7, the profits attributable to a PE can include profits from outside the country in which the PE is located. These treaty rules are discussed further in Chapter 8, section 8.8.5.

Business income derived by a nonresident is usually taxed by the country in which the income is earned on a net basis, and the rules for the computation of

business income are generally the same as the rules for residents. The nondiscrimination article of tax treaties (Article 24(3) of the OECD and UN Model Treaties) requires the source country to tax a PE of a resident of the other state no less favorably than a resident of the source country carrying on the same activities. The nondiscrimination article is discussed in more detail in Chapter 8, section 8.8.1. Once a nonresident has met the minimum threshold requirement for taxation in the source country (usually the existence of a PE in the source country), domestic tax rules will apply in order to determine the amount of income from the business that is subject to tax. In some countries, once a nonresident has a PE in the source country all the nonresident's income from the source country becomes taxable. However, most countries do not follow this **force-of-attraction principle**. Instead, only the income from the business carried on in the source country is taxable (although other amounts, such as investment income, may be taxable on a different basis). Under the OECD Model Treaty, there is no force of attraction; only income that is attributable to the PE is taxable by the source country. Under the UN Model Treaty, there is a limited force-of-attraction rule: the source country is authorized to tax any business profits from the source country of the same or similar kind as those derived through the PE. The treaty rules for the attribution of profits to a PE are discussed in Chapter 8, section 8.5.

5.8.1.2 Branch Taxes

As noted several times in this Primer, taxpayers generally have the choice of doing business in a country in the form of a branch or a separate legal entity, usually a company. For corporate taxpayers, this choice is usually described as a choice between a branch and a subsidiary. If a corporation resident in one country forms a subsidiary corporation in another country, the subsidiary will likely be treated as a separate legal and taxable entity, and therefore as a resident of the other country (assuming that the subsidiary's place of management is located in that country). If a corporation establishes a branch in another country, the branch is simply a part of the corporation. As a resident of the source country, a subsidiary of a nonresident corporation is ordinarily taxable on its worldwide income, whereas in respect of a branch only the domestic source income attributable to the branch is usually taxable by the source country. If, however, the subsidiary earns exclusively domestic source income (i.e., all of its income is earned in the country in which it is resident), there is no difference between the subsidiary and a branch in this regard.

There is a significant difference with respect to the tax consequences of the repatriation of funds from a branch or subsidiary. If a subsidiary pays a dividend to its nonresident parent, the country in which the subsidiary is resident may impose a withholding tax on the gross amount of the dividend. In contrast, if funds are withdrawn from a branch and repatriated to the head office of the nonresident corporation, there is no dividend or other payment on which the source country can levy tax. Therefore, nonresidents may prefer to do business in a country through a branch rather than a subsidiary in order to avoid withholding taxes on dividends and other intercorporate payments. Some countries (e.g., Canada and the United States),

have adopted special branch taxes in order to equalize the treatment of branches and subsidiaries. These branch taxes can be quite complicated because of the need to impose a tax that is equivalent to a withholding tax on dividends on the basis of some type of proxy for dividends. Other countries impose a slightly higher rate of tax on nonresidents carrying on business in the form of a branch in order to make up for the lack of withholding tax on the repatriation of funds from branches. Both of these measures appear to violate the nondiscrimination article of a typical tax treaty, although they are arguably justifiable on tax policy grounds.

If borrowed funds are used to finance the activities of a branch, the interest expense incurred with respect to the funds is ordinarily deductible in computing the profits of the branch under both domestic law and tax treaties. Such interest expense erodes the tax base of the country in which the branch is located; however, the interest is not usually subject to withholding tax because the interest is paid by a nonresident. A few countries attempt to subject such interest to withholding tax.

5.8.2 Income from Immovable Property

The ownership or use by a nonresident of immovable property situated in a country is clearly sufficient to justify jurisdiction to tax by that country. In addition, the existence of the immovable property operates as a threshold requirement and as a source rule. The country in which immovable property is situated is entitled to tax the nonresident owner on any income derived from the property or any capital gains derived from the disposal of the property. Articles 6 and 13(1) of the OECD and Model Treaties confirm the source country's right to tax income and gains from immovable property on this basis.

Income from immovable property is treated differently from income from business under the OECD and UN Model Treaties. Although the location of immovable property in a country may be seen as the equivalent of a PE in terms of nexus, under Article 6 there is no requirement for income from immovable property to be taxed on a net basis, as there is for business profits under Article 7. In any cases of conflict between Articles 6 and 7, Article 6 clearly prevails (see Article 6(4) and Article 7(4) of the OECD Model Treaty and Article 6(4) and Article 7(6) of the UN Model Treaty). As a result, there is nothing in a typical tax treaty to prevent a country from taxing income from immovable property on a gross basis, and, in fact, some countries tax some types of income from immovable property on a presumptive basis. It is important, therefore, to understand how a country defines and taxes income from immovable property under its domestic law.

5.8.3 Income from Employment

A country has jurisdiction to tax nonresident employees if the employment activities are performed in the country or the income is derived from the country, or even if the

benefits from the employment activities are used or consumed in the country. In most countries, there is no minimum threshold for the taxation of nonresident employees, although the United States provides an exemption for nonresident employees who are paid by a nonresident employer, earn not more than USD 3,000, and are present in the United States for not more than ninety days. If a nonresident is employed by a resident employer, any tax on the employee is relatively easy to enforce by requiring the employer to withhold the tax. Even if the employer is a nonresident, the tax can be effectively enforced if the employer has a PE in the source country. In other situations, any tax imposed on a nonresident employee who spends a few days in a country performing services may be difficult to enforce.

Under the OECD and UN Model Treaties, income from employment derived by a nonresident employee is taxable by the source country only if the employee is present in the country to perform the employment services. An exemption is provided for nonresident employees if they are present in the source country for less than 183 days, they are not paid by a resident employer, and their remuneration is not deductible for purposes of computing the income of a PE that the nonresident employer has in the source country.

5.8.4 Investment Income: Dividends, Interest, and Royalties

Most countries tax certain investment income derived by nonresidents. For this purpose, it is necessary to define the types of investment income that are taxable and, in particular, to distinguish between business income and investment income, as discussed in section 5.8.1.1. This distinction cannot be made solely on the basis of the nature of the income because, for example, interest earned by a financial institution from lending money is clearly income from business, whereas interest earned by an individual investor is investment income.

The distinction is important because, typically, investment income is taxable by source countries through a withholding tax at a flat rate on the gross amount paid to nonresidents, while business income is usually taxable on a net basis by way of an assessment. It may be questioned whether a gross basis withholding tax is appropriate as part of an income tax; however, in practice, the difficulty of enforcing tax imposed on the investment income of nonresidents makes withholding taxes generally acceptable if the rate is limited so that the withholding tax approximates the tax that would be imposed at ordinary rates on net income. This explains why withholding tax is generally limited to amounts in respect of which the nonresident is unlikely to have incurred substantial expenses to earn those amounts.

The imposition of tax on the gross amount of interest, rent, or royalties can be excessive in certain circumstances, as explained in section 5.6 above.

Investment income derived by nonresidents is typically taxed without any threshold requirement under either domestic law or tax treaties; in general, it is considered to have its source in the country in which the payer is resident. The same source rule is used in Article 10 through 12 of the OECD and UN Model Treaties. Several countries, however, have special source rules for certain types of investment income.

For example, interest and royalties may be considered to be earned where the funds or property are used.

5.8.5 Capital Gains

The taxation of capital gains realized by nonresidents presents special problems for countries that tax such gains differently from business income. Many countries tax capital gains derived by nonresidents from the disposal of immovable property situated in their countries, property of a business carried on (often through a PE) in their countries, and substantial participations in resident companies, partnerships, and other legal entities. Most countries do not tax nonresidents on capital gains from the disposal of shares of resident companies other than land-rich companies (companies whose assets consist primarily of immovable property located in the country) and substantial participations. This pattern is reflected in Article 13 of the OECD and UN Model Treaties, except that, under the OECD Model Treaty, source countries are not allowed to tax capital gains from substantial participations.

The enforcement of tax on the capital gains of nonresidents raises special difficulties. If a nonresident sells immovable property situated in a country, that country's tax on the capital gain can be enforced by requiring the purchaser to withhold an amount on account of the seller's tax from the purchase price, unless the nonresident prepays the tax or provides security for the payment of the tax, such as a bank guarantee. If the prepayment is excessive, the nonresident is usually entitled to file a return to claim a refund of the excess. Even if the nonresident sells the property to another nonresident, the tax can usually be enforced in this way by refusing to allow the purchaser to register the property unless the tax has been paid.

In the case of the sale of the property of a business carried on in a country by a nonresident, the tax on any capital gains from the disposal of the business assets can be enforced in the same way as tax on the income from the business, although the tax may be difficult to collect where the nonresident sells all the assets of the business.

The taxation of capital gains in respect of shares of resident companies holding immovable property is necessary to prevent the easy avoidance of the tax on gains from the disposal of immovable property by holding the property in a resident company and then selling the shares of the company rather than the immovable property itself. The rule in Article 13(4) of the OECD and UN Model Treaties provides that a country is entitled to tax gains from the sale of shares of a resident company if more than 50 percent of the value of the shares of the company is attributable, directly or indirectly, to immovable property situated in the country. For capital gains from the sale of shares of land-rich resident companies, or substantial participations in resident companies, the only effective method of enforcing the tax is to place an obligation on the purchaser to withhold the tax from the purchase price. This method of enforcement is not as effective for shares as for the disposal of immovable property because in the case of immovable property, the tax can be registered as a lien against the property, whereas in the case of shares, the immovable property is owned by the company.

5.9 ADMINISTRATIVE ASPECTS OF TAXING NONRESIDENTS

5.9.1 Introduction

The difficulties of tax administration are exacerbated with respect to the taxation of cross-border transactions and investment involving both residents and nonresidents. Collecting tax from nonresidents earning domestic source income is different from collecting tax from residents because, unlike nonresidents, residents are usually present in a country (or have substantial connections with the country) and are subject to its legal system. It makes little sense for a country to impose a tax on nonresidents that it cannot collect. In this section, two major problems are examined: obtaining the necessary information and collecting the tax.

5.9.2 Obtaining Information about Domestic Source Income of Nonresidents

The basic question here is: what information do source countries need to collect tax effectively from nonresidents? First, they need basic information, such as name, address, and taxpayer identification number if available, to identify nonresidents earning domestic source income. Second, they need information to determine whether nonresidents are carrying on business in their countries, or have PEs there, or are earning investment income there. Third, information is necessary to determine or verify the computation of a nonresident's domestic source income (revenue and expenses). Fourth, information is necessary concerning transactions with related persons, especially with related persons who are residents of the source country. Fifth, if the nonresident is claiming a reduction of or exemption from source country tax under an applicable tax treaty, the source country should have sufficient information to verify whether the benefits of the treaty should be granted.

In some cases, the necessary information can be obtained by imposing reporting requirements on the nonresidents themselves. Ideally, however, the tax authorities should have independent information to verify information provided by nonresidents.

In other cases, information can be obtained from residents who have relationships or transactions with nonresidents. For example, residents paying dividends, interest, royalties or other amounts to nonresidents can be required to report basic information about the nonresident recipients and the amount and nature of the payments. Imposing these types of reporting requirements on third persons may result in their incurring significant compliance costs. As a result, in adopting such reporting requirements, a source country must carefully balance the need for information against the compliance costs imposed on third parties. A country should not ask for information that it cannot use effectively.

Information should be provided in electronic format if the tax authorities have the necessary technology to use information in this format. If the tax authorities have information in electronic format and have taxpayer identification numbers, they will be able to match information from various sources. The information should be provided in a consistent format from year to year. It can be filed with the nonresident's tax return

(assuming that a return is required) or filed separately, or retained by the taxpayer for possible inspection by the tax authorities.

In many situations, the necessary information is located outside the source country. If the information is in the possession of the taxpayer, a penalty can be imposed on the taxpayer for failing to produce the information on a timely basis. Some countries have adopted special rules to preclude a taxpayer from introducing in any subsequent legal proceedings foreign-based information that is not disclosed to the tax authorities when requested; such a rule is ineffective if the taxpayer discloses all of the information favorable to the taxpayer's case. If the information is in the possession of an unrelated third party, the taxpayer should not be penalized for not producing the information. If the information is held by a related party, however, it may be appropriate to impose penalties in certain circumstances.

If there is a treaty in place between the source country and the country in which the nonresident is resident, foreign-based information may be obtained through the exchange-of-information provision in the treaty. Bilateral tax treaties based on the OECD or UN Model Treaties contain an exchange-of-information article (Article 26), which authorizes the tax authorities to exchange many types of information in response to a specific request from the other country, and to do so automatically. In addition, several countries have recently entered into Tax Information Exchange Agreements (TIEAs) with countries (such as tax havens) with which they do not have comprehensive tax treaties. Comprehensive tax treaties with these countries are not necessary, but exchange of information can be useful for both residence and source countries. Exchange of information is also covered by multilateral agreements among the Nordic countries, the European Union, and a joint Convention on Mutual Administrative Assistance in Tax Matters of the Council of Europe and the OECD, which entered into force in 1995; after a slow start, over ninety countries have now been signed this Convention. Exchange of information under tax treaties is discussed in more detail in Chapter 8, section 8.8.4.

5.9.3 Collection of Tax from Nonresidents

There are two basic ways of determining the tax payable by nonresidents: assessment and withholding. Assessment is typically used in situations in which nonresidents are taxed on a net basis, whereas withholding is typically used for passive investment income. Assessment involves the determination of a nonresident's income subject to tax and tax payable, usually by way of the filing of a tax return. If the nonresident does not pay any tax owing, the source country can take action to enforce the tax in accordance with its domestic law.

Withholding operates by the imposition of an obligation on persons (usually residents) paying certain amounts to nonresidents to withhold tax at a specified percentage from those payments and remit the tax to the tax authorities on behalf of the nonresident. There are two types of withholding. Provisional or interim withholding is purely a collection device. The amounts withheld are remitted to the tax authorities on account of the nonresident taxpayer; they are treated, in effect, like installments of tax

paid by the nonresident. The nonresident is under an obligation to file a return and either pay any tax owing in excess of the amount withheld or receive a refund of the amount withheld in excess of the tax payable. If the nonresident does not file a return, the tax authorities have access to the amounts withheld to satisfy the nonresident's tax liability.

Provisional withholding by employers is often used to collect tax from salary and wages paid to employees. Final withholding is a tax imposed on the gross amount (or a percentage of that amount) of the payment to a nonresident. It is final because the nonresident is not entitled to file a return on the basis of its actual net income. Although a final withholding tax is not, in form, an income tax, if the rate of withholding tax is set appropriately, it is recognized as an internationally accepted proxy for an income tax because of the difficulties in collecting tax from nonresidents.

Obviously, if a nonresident has assets in the source country or is physically present in the source country, collection action can be taken by the source country directly against the nonresident. In these circumstances, which may include nonresidents carrying on business in a country, source countries typically impose tax by means of an assessment levied on the nonresident. In countries with self-assessment systems, nonresidents are expected to file tax returns in which they report their revenue and expenses and determine their tax payable. Source countries can audit nonresidents' tax returns and enforce tax payable by nonresidents in largely the same way as with residents. Often such nonresidents may be required to pay periodic installments of tax throughout a taxation year; they may also be subject to interim or provisional withholding on certain amounts paid to them and by them.

If, however, the nonresident is not present and does not have significant assets in the source country, the source country must take special measures to collect its tax. First, the source country might consider obtaining a court judgment for the unpaid tax against the nonresident from the country's courts and then seeking enforcement of that judgment by the courts in the nonresident's country of residence. The problem with this course of action is that many countries will not enforce other countries' criminal and tax judgments (this is widely known as the revenue rule). Second, the source country may consider requesting assistance in the collection of the unpaid tax from the country of residence pursuant to the tax treaty between the two countries, if that treaty has an article dealing with Assistance in Collection based on Article 27 of the OECD and UN Model Treaties. However, Article 27 was added to the OECD Model only in 2002 and to the UN Model in 2011, and has been included in relatively few treaties to date. Third, if the source and residence countries are parties to a multilateral convention dealing with administrative assistance in tax matters, such as the Convention on Mutual Administrative Assistance in Tax Matters, referred to above in section 5.9.2 in connection with exchange of information, the source country can request the residence country to collect the source country's tax as if it were tax owing to the residence country.

Many countries have concluded that withholding is the most effective method of collecting tax from nonresidents that do not have a significant presence in the country. The withholding is usually provisional with respect to amounts such as employment income, other income from services, and sometimes rents and royalties, because the

net income may be significantly less than the gross amount. Nonresidents have the right to file a return and obtain a refund of any excess tax withheld. Often, however, as a practical matter, provisional withholding operates as a final withholding tax because the nonresident may choose not to file a return unless the amount withheld is substantially in excess of the amount of tax payable. Also, unfortunately, some countries may make it difficult, either deliberately or inadvertently through inefficient tax administration, for nonresidents to obtain refunds.

A final withholding tax on the gross amount of certain payments is a convenient and effective method of collecting tax from nonresidents, especially for developing countries that lack sufficient administrative resources. However, unless the rate of tax is quite low, a final withholding tax is inappropriate for amounts in respect of which a nonresident is likely to have incurred significant expenses. This may be the case where amounts such as dividends, interest, or royalties constitute profits of a business carried on by a nonresident.

Another method of providing relief from excessive withholding taxes is allowing nonresidents to elect to pay tax on a net basis; if the election is made, the nonresident must file a return and pay tax on the net income. Several countries provide this type of election with respect to income from immovable property. A nonresident deriving rent from immovable property located in a country will often be subject to withholding tax on the gross amount of the rent. Although such a withholding tax on rental income from immovable property is in accordance with Article 6 of the OECD and UN Model Treaties, the nonresident may have incurred significant expenses with respect to the immovable property, such as mortgage interest, property taxes, and maintenance. As a result, a gross basis withholding tax, even at a relatively low rate, may well be excessive and the ability for the nonresident to make an election to pay tax on a net basis can provide relief.

An example of the tension between the effectiveness and the appropriateness of final withholding is the taxation of consulting, technical, and management fees by developing countries. Under the OECD and UN Model Treaties, such fees are business profits that are taxable by the source country only if the nonresident spends more than 183 days in the source country or has a PE or fixed base in the source country and the fees are attributable to the PE or fixed base. In most cases, taxpayers can arrange their affairs so that they can earn substantial fees without having a PE or fixed base in the source country (or without spending more than 183 days in the source country under Article 14(1)(b) of the UN Model Treaty).

This result is often unacceptable to developing countries, and some of them have taken the position that technical and management fees are royalties subject to withholding tax. Several countries, such as India, Jamaica, Kenya, Mongolia, Tanzania, and Vietnam, have included special articles in their tax treaties allowing them to tax consulting, technical, and management fees on a gross basis, but at a limited rate. The UN Committee of Experts is currently working on a new article dealing with consulting, technical, and management fees to be included in the UN Model Treaty. This new article would permit source countries to tax such fees through a withholding tax on the gross amount, but at a limited rate to be agreed on by the parties to the treaty. Such fees would be taxable by a country if the payer of the fees is a resident of the

country or a nonresident with a PE or fixed base in the country. The nonresident would not be required to meet any threshold (such as a PE or fixed base) and the source country would be entitled to tax even where the services are rendered outside that country. The proposed article on consulting, technical, and management services is dealt with more extensively in Chapter 9, section 9.3.