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Gross taxation at source: limitations of the international
tax framework

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limitations of the international tax framework***

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List of Abbreviations

CFE Statement – Opinion Statement of the CFE on Double Tax Conventions and the Internal Market: factual examples of double taxation cases, July 2010

CIT – Corporate Income Tax

CITA – Nigeria’s Companies Income Tax Act

Commentary – Commentaries on the OECD Model (unless stated otherwise)

DTC – Double Tax Convention

EEA – European Economic Area

EU – European Union

Experts Report – Report of the General Meeting of Government Experts on Double Taxation and Tax Evasion of the League of Nations, of 31st October 1928

Fiscal Committee – Fiscal Committee of the Organisation for European Economic Co-operation (today, Organisation for Economic Co-operation and Development)

IBFD – International Bureau of Fiscal Documentation

ICTA – United Kingdom’s Income and Corporation Tax Act 1988

IMF – International Monetary Fund

Introduction – Introduction to the Commentary

IRC – United States of America’s Internal Revenue Code

ITA – South Africa’s Income Tax Act

ITC – Italy’s Income Tax Code

ITL – Germany’s Income Tax Law

ITLR – International Tax Law Reports

London Draft – Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property Prepared by the League of Nations

OECD – Organisation for Economic Co-operation and Development

OECD Model – 2008 OECD Model Tax Convention on Income and on Capital

OFLR – Offshore Financial Law Reports

PE – Permanent Establishment

STC – Simon’s Tax Cases

TIOPA – Taxation (International and Other Provisions) Act 2010

UK – United Kingdom

UN Model – 2001 United Nations Model Double Taxation Convention between the Developed and Developing Countries

US – United States of America

US Model – 2006 United States Model Income Tax Convention

Vienna Convention – Convention on the Law of Treaties, of 23rd May 1969

I. Introduction

“How wonderful that we have met with a paradox.

Now we have some hope of making progress.”

Niels Bohr

a) Subject

The inability of non-resident taxpayers without a PE¹ in the source State² to deduct expenses may give rise to a charge that exceeds a reasonable taxation on a profit margin, if not the margin itself. Such assessment of tax on a gross basis (hereinafter referred to simply as “**gross taxation**”) may be alleviated for certain categories of income, subject to reduced tax rates under the domestic law of source countries. Nonetheless, gross taxation with reduced rates often entails a significantly higher tax liability than that arising from net taxation with standard rates (*“paradoxically, taxation where a permanent establishment does not exist might be far more burdensome than if one did”*³). Above all, *“This form of taxation is... inefficient, as it does not take into account the different cost structures of individual taxpayers and often over-taxes some revenues and under-taxes others”*⁴. Gross taxation may impact cross-border transactions to the point of dissuasion.

The core of the existing international tax framework, modelled by the interaction of DTCs (the vast majority of which is based on the OECD Model) is the mitigation of double taxation. This dissertation endeavours to assess how the mechanisms for preventing double taxation address gross taxation, with a particular focus on the credit method. The OECD Model and the Commentary are the starting point of the analysis, followed by a concise examination of sample legislation and jurisprudence in selected countries. Finally, some potential solutions are briefly examined.

¹ This analysis focuses solely on non-residents which have no PE in the source State to which the relevant income may be attributed.

² “Source State” means hereinafter the State to “*which... primary taxation of an item of income is allocated*” (Vogel (2005), p. 420).

³ OECD (1983), §18/iv.

⁴ OECD (2004a), §259.

b) Scope

The subject of this dissertation involves a wide range of issues and leads which, if followed, would require far more than the words available. It is thus essential to clarify its scope.

The issues analysed in respect of the OECD Model might also be examined with regard to other convention models, such as the UN and the US Models. Since the mechanisms employed to mitigate juridical double taxation are the same and gross taxation is more “tolerated” in the UN Model⁵, the conclusions of this dissertation should apply to the US Model, and *a fortiori* to the UN Model, and DTCs based thereupon.

In a DTC context, one may debate gross taxation as a matter of tax policy, but not reasonably challenge its application on the basis of the current international tax framework. EU law is here disregarded because the crux of the analysis would be shifted from how the methods for the prevention of double taxation deal with gross taxation to ascertaining to what extent the latter is even admissible⁶.

The discussion of other international tax law issues (e.g., administrative matters related to the application of both gross taxation and the methods for preventing double taxation, specific issues associated with income derived by artistes and sportsmen, topics relating to the protection of taxpayers, among many others) might complement this work. However, instead of perfunctory remarks that would do no justice to their relevance, the author opted for leaving them aside entirely. The main challenge in encapsulating such a fascinating subject in 15,000 words was drawing the thin line between pertinent and crucial.

⁵ An example is the ability of source countries levying tax on the gross amount of royalties, under Article 12.

⁶ The now called Court of Justice addressed this issue with respect to professional and business income in C-234/01 *Gerritse*, C-290/04 *Scorpio*, C-345/04 *Centro Equestre* and C-346/04 *Conijn*, and interest income in C-282/07 *Truck Center* and C-105/08 *Commission v. Portugal*. Gross taxation has also been criticised by reference to dividends (see Aramini (2008), p. 476).

II. Context of gross taxation at source

a) The work leading to the OECD Model⁷

Gross taxation was an ordinary phenomenon for those involved in the work commenced in 1921 by the League of Nations and revived in 1956 by the Fiscal Committee and its Working Parties. Actually, gross taxation was explicitly acknowledged in some DTCs: “*direct taxes are deemed to be taxes levied directly... on income (net or gross income) or on capital or increase to capital...*”⁸.

This does not mean the adverse consequences of gross taxation were unknown. A note prepared for Working Party no. 8 by the Belgian Delegation in October 1958 stressed that “*a moderate tax computed on the gross amount of the royalties... would be to disregard a traditional principle in income taxation, namely, that the tax should fall on the net income less expenses. Taxing of the gross income at the source leads to injustices...*”. In the 20th and 21st sessions of the Fiscal Committee, one of the UK delegates reported the impression that “*a tax of 5 per cent on gross income in fact represented a tax of 25 to 30 per cent on the net income*” of film rents. He further argued that, if these were to be included in the royalties article, “*the word ‘income’ in paragraph 4 should be replaced by the word ‘payments’*”.

A possible explanation why gross taxation was “tolerated” may be that the purpose of the project was to allocate taxing rights between countries, a Herculean task in itself⁹. Trying additionally to set rules on how such taxing rights would be exercised would have proved utopian¹⁰.

This is illustrated in the minutes of the 17th session of the Fiscal Committee. One of the delegates for the US “*observed that bodies granting loans more often than not required the interest to be clear of tax, which added to the*

⁷ DTCs, working papers, reports and minutes referred to in this section were accessed between 9th and 11th April 2010 at <http://www.taxtreatieshistory.org/>.

⁸ Article 1(1) of the Germany–Switzerland DTC of 15th July 1931.

⁹ The Report on the Taxation of Interest of Working Party no. 11 (14th January 1959) alluded to “*different, not to say conflicting, proposals as to the taxation of interest*”, for instance.

¹⁰ Justifying the absence of computational rules from the scope of DTCs (from a PE and business profits perspective), see Arnold (2007), *passim*.

borrower's burden where there was a tax at the source on the interest". In other words, lenders would impose gross-up clauses shifting the tax cost to the borrowers. Additionally, *"He pointed out that the interest did not constitute a net income to the lender"*. The OECD Model still reflects today the compromise arising from the ensuing discussion, with delegates *"in favour of exclusive taxation in the country of the creditor's residence"* and others demanding for the source country the highest tax rate possible (*"not less than 15 per cent"*). An agreement was eventually reached (*"limiting the tax levied by the country of source to 10 per cent"*), with Working Party no. 11 *"mindful that truth is as remote from extremes as is virtue"*¹¹.

b) The OECD Model today

The possibility of gross taxation at source is therefore clear for dividends and interest (as well as royalties, in the UN Model and in many DTCs, even if based on the OECD Model). With the exceptions of (i) income which the source State may not tax and (ii) business profits of a PE due to Article 24(3), the source State is bound by no provision of the OECD Model in taxing other categories of income. Therefore, they are classified by the Commentary as *"income... that may be taxed without any limitation in the State of source"* (Introduction, §21).

Theoretically, an argument might be made that gross taxation of non-residents is intrinsically discriminatory *vis-à-vis* resident taxpayers. However, nationals of different Contracting States are only in a comparable position when resident in the same Contracting State, as clarified in 1997 by the introduction in Article 24 OECD Model of the expression *"in particular with respect to residence"*¹². Therefore, even where personal circumstances appear to have little bearing upon a taxable event – e.g., rental income¹³ –, the distinction between residents and non-

¹¹ First Report (14th January 1959). The position of countries changed through times (e.g., the US defended source taxation in the early 1920s (see Kemmeren, Eric (2006), p. 436, fn. 61)).

¹² See Baker (2009), 24B.11, and the Commentary on Article 24 (§7).

¹³ Neither Baker (2009), 6B.01 ff. (implicitly), nor Vogel (1999), p. 375, consider that the source State is restricted as regards the determination of income. Both the latter and Holmes (2007) p. 284, appear to assume that in practice some deductions will apply. However, none claims that such deductibility is

-residents¹⁴ may suffice to argue they are not in a comparable position¹⁵. Hence, it is not discriminatory for the source State to tax the net income of its residents and the gross income of the non-residents¹⁶, or to restrict the deductibility of certain expenses of the latter.

The above does not mean the OECD is pleased with the state of affairs, particularly regarding interest derived by financial institutions. Specifically, “*taxation by the State of source is typically levied on the gross amount of the interest and therefore ignores the real amount of income derived from the transaction for which the interest is paid*”. This is because “*a bank generally finances the loan which it grants with funds lent to it and, in particular, funds accepted on deposit*” (Commentary on Article 11, §7.7). In light of the Vienna Convention¹⁷, it is at least unsatisfactory that the interpretation of one of the key concepts of a DTC (income) leads to its object (allocation of income taxing rights) becoming distorted (if gross taxation “*ignores the real amount of income*”, income tax becomes closer to a turnover tax).

Furthermore, the Commentary recognises that “*the amount of [source] tax may prevent the transaction from occurring unless... [it] is borne by the debtor*” (idem), acknowledging that only gross-up clauses (laden with significant secondary effects and even forbidden in some countries¹⁸) can remove this obstacle to international trade and investment¹⁹.

c) The position of countries

Although a thorough discussion of the justifications for gross taxation at source falls outside the scope of this dissertation, some brief remarks may assist in illustrating the limitations of the international tax framework in addressing it.

imposed by Article 6. The source State’s “*domestic rules determine how the income should be computed or taxed*” (Rohatgi (2005), p. 136).

¹⁴ However, the inability to enforce against non-residents, which represented a fundamental difference *vis-à-vis* residents, is disappearing (see Baker (2002)).

¹⁵ See Vogel (1999), pp. 1292-1293, on the application of this reasoning to non-individuals.

¹⁶ See OECD (2007), §23.

¹⁷ On the application of the Vienna Convention to the interpretation of DTCs see, among others, Baker (2009), E.02 ff., Vogel (1999), pp. 35 ff., and Rohatgi (2005), pp. 38 ff.

¹⁸ See Vogel (1999), p. 721.

¹⁹ On the impact of withholding taxes on gross income on cross-border flows, see Egger *et alia* (2006).

Gross taxation is simpler for both taxpayers and tax authorities, as it provides certainty on the taxable income²⁰. Tax authorities also benefit from more straightforward tax audit procedures, since the “*source country does not generally have access to all the information necessary to calculate tax correctly on a net basis*”²¹. It is true that the progress of tax cooperation²² and the evolution of information technology have changed the international tax landscape, allowing tax authorities to increasingly access data on non-resident taxpayers in a relatively timely and efficient manner²³. Nonetheless, particularly when coupled with withholding tax mechanisms, gross taxation alleviates compliance costs for taxpayers and collection efforts for the tax authorities²⁴. In the UK, those authorities have described (gross) taxation at source as “*the great buttress of Income Tax stability and efficiency*”²⁵. The relevance of “practicality” for some literature has been stressed to the point of being claimed that “*The concept [of PE] was invented to enable gross-basis taxation or tax exemption in case the local activities of non-residents are not significant enough to justify the chore of identifying the net income*”²⁶.

Another justification for gross taxation is the prevention of domestic tax base erosion. Unless non-residents are taxable in the source State on the full amount they charge to local taxpayers (which in principle the latter deduct for purposes of computing their taxable income), there is effective tax base erosion (e.g., local taxpayers deduct 100 whereas non-residents are taxed on 20). This erosion is the more significant the less local costs the non-resident taxpayer incurs, as is the case, for instance, of passive income²⁷, where the connection of the non-resident with the source State

²⁰ See Ault/Sasseville (2010), p. 105.

²¹ Rixen (2008), p. 70. See also Ault/Sasseville (2010), p. 115.

²² Involving both DTCs and specific exchange of information agreements, notably those driven by the OECD co-ordinated efforts against uncooperative jurisdictions. Some studies have concluded that information exchange may be more efficient than withholding taxes (Keen/Ligthart (2004) and Keen/Ligthart (2005)). The OECD has also been active in managing compliance risks (see OECD (2004b), *passim*).

²³ An example of such impact with respect to transfer pricing is provided by Jacobs *et alia* (2004).

²⁴ See Holmes (2007), p. 214.

²⁵ See Soos (1995), p. 50.

²⁶ Lee (2004), p. 43.

²⁷ Passive income is employed in the broad sense of income derived from passive activities (i.e., without an involvement “*in the operation of the activity on a regular, continuous, and substantial basis*”, as defined by the IRS in its “Tax Topics” – <http://www.irs.gov/taxtopics/tc425.html>, accessed on 13th March

may be more superficial, hence less prone to giving rise to local costs (which might “restore” some of the local tax base)²⁸.

Finally, gross taxation, particularly through withholding²⁹, is also a blunt but nonetheless robust instrument against tax avoidance, since the conduct of the taxpayer in respect of costs is irrelevant, significantly reducing the scope for “illegitimate planning” and straightforward abuse.

Irrespective of the reasons, gross taxation, particularly when combined with withholding tax, does not appear to recede and in several jurisdictions its scope is actually expanded by exacting tax authorities, sometimes supported by courts³⁰.

d) The impact on taxpayers

At least within the OECD, gross taxation at source is unilaterally alleviated by mitigated domestic rates³¹, further reduced by DTCs in many instances. However, it is highly unlikely that “*withholding tax rates on gross income are sufficiently below the annual income tax rates on net income to more or less produce the same amount of tax collected*”³² from taxpayers individually considered, particularly those operating with low net margins, often the case in high-volume activities such as bank lending.

In the last 25 years, the average net interest margin (i.e., disregarding overheads and other expenses) of US banks ranged between 3% and 5%³³.

2010). However, the distinction between passive and active income is increasingly blurred (see OECD (2004a), §59, and Vogel (2002b), pp. 260 ff).

²⁸ An “unjustified” erosion would be unlikely in a transparent market with effective transfer pricing rules. Considering the example of cross-border loans and that it is more practical to deal with local counterparties, in principle funds would only be borrowed abroad if (i) domestic funds were insufficient (if available locally but externally refunded, the erosion would also occur, but at the level of a different taxpayer) or (ii) available in less attractive conditions. Since it is almost impossible to achieve so perfect a market, such erosion is documented, e.g., in Jarass/Obermair (2008).

²⁹ See Rixen (2008), p. 203. The withholding itself ensures “*the collection of tax owed on income for which there is a high possibility of not being reported*” (Akamatsu (2007), p. 413). Defending a coordinated withholding tax to prevent tax evasion, see Avi-Yonah (2007), p. 136, and Avi-Yonah (2008).

³⁰ For the example of India’s encompassing approach to withholding taxes, see Lowell *et alia* (2005).

³¹ As compared to CIT rates applicable to net income. There are, of course, exceptions (e.g., Sweden, with a 28% CIT rate and a 30% withholding rate on dividends).

³² Holmes (2007), p. 217. This is why, in gross taxation scenarios (and not simply differences in deductibility of certain expenditure) the “*protection* [of a residence State adopting the full credit method] *against excessive levels of tax on the foreign measure of income*” (Baker (1998), p. 454) is more theoretical than real.

³³ See <http://research.stlouisfed.org/fred2/series/USNIM> (accessed on 15th August 2010).

According to the IMF, between 2003 and 2008 the average net interest margin in the most representative European economies was even lower (0.9%-1.5%)³⁴. However, assuming an interest rate of 10%, a bank subject to CIT rates of 25%, 30% and 35%³⁵ on a net basis would only pay the same tax as a non-resident bank subject to gross taxation at reduced rates of 5%, 10% and 15% (the most common in DTCs)³⁶ if it achieved a net interest margin between 1.43% and 6%³⁷.

Domestic CIT rates	Non-resident reduced rates	"Required" net interest margin	Tax due
25%	5%	2,00%	5
	10%	4,00%	10
	15%	6,00%	15
30%	5%	1,67%	5
	10%	3,33%	10
	15%	5,00%	15
35%	5%	1,43%	5
	10%	2,86%	10
	15%	4,29%	15

The comparison of the impact between net and gross taxation, even with a CIT rate above the average and disregarding all other expenses, illustrates how cross-border lending is hampered by gross taxation:

"Realistic" net interest margin	Domestic CIT rate	Non-resident reduced rates	Tax due on net basis	Tax due on gross basis
1,00%	30%	5%	3	5
		10%	3	10
		15%	3	15
3,00%		5%	9	5
		10%	9	10
		15%	9	15
5,00%		5%	15	5
		10%	15	10
		15%	15	15

³⁴ See <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/statappx.pdf> (accessed on 15th August 2010).

³⁵ In 2006, 22 of the 30 OECD countries had CIT rates ranging between 25% and 35% (Avi-Yonah (2007), p. 135). In 2009, the average was 26.4%, the lowest and the highest being Ireland (12.5%) and Japan (43%), respectively (Zielke (2010), p. 91).

³⁶ For a similar exercise with analogous conclusions on artistes (comparison between gross taxation at source and the average progressive taxation in the residence State), see Molenaar (2002), pp. 150-152. See also Molenaar (2006), especially pp. 179 and 192, and the CFE Statement, p. 5 (although from a EU perspective, the comments are fully applicable).

³⁷ If overheads and other expenses were considered, the margin would have to be even higher.

III. The response of the OECD Model to gross taxation at source

a) The work leading to the OECD Model³⁸

In the Experts Report, under Article 3 (*Relief through deductions and refunds*) the residence State would be required to “deduct from its tax on the total income the lesser of the two following amounts: (a) The tax imposed by the other Contracting State on income taxable by priority therein; or (b) An amount which represents the same proportion of the tax payable on the total income as the income taxable by priority bears to the total income”. In the 1946 London Draft, Article XIII provided a more refined formulation to the second element of the equation: “The amount which represents the same proportion of the tax of the State of fiscal domicile on the entire net income of the taxpayer as the net income taxable in the other State bears of the entire net income”. If the interpretation of the Experts Report might be debatable – “the income taxable by priority” might be understood as gross income, as computed by the source country –, in the London Draft there appears to be a clear indication that the income taxable in the source State must be taken into consideration for this purpose as net of expenses.

It is worth mentioning that when this work was picked up by the OECD, some DTCs had in the meantime adopted a different approach. In the Sweden-Norway DTC of 21st June 1947, Article 7 allowed the source State to withhold 10 per cent of the gross amount of the dividends. However, it also provided that “the other State shall allow, from its national income tax levied on the dividends, a special deduction in respect of the tax deducted at the source in the first State, which deduction shall amount to not less than 5 per cent of the gross amount of the dividends”. An equivalent method, with the same rates, appeared in Article 8 of the France-Norway DTC of 22nd September 1953.

Unfortunately, although gross taxation at source was known to “lead to injustices”, the need to find a compromise was propitious to either

³⁸ Brief remarks on earlier appearances of double tax relief methods are found in Avery Jones *et alia* (2006), p. 253.

disregarding or accepting its consequences. Therefore, none of the versions of the Report on Methods for Avoidance of Double Taxation of Income, prepared by Working Party no. 15, makes a single reference to gross taxation. It is possible that at the time its members (Denmark and Ireland) were not those countries whose taxpayers were more exposed to its detrimental impact (whereas in the US and the UK, as illustrated above, there was a clear perception of its implications on interest and royalties). In its Preliminary version (24th February 1959), the Report noted that “*The limited rate of tax in the state of source will as a rule be substantially less than the rate of tax in the State of residence*”. The focus was clearly the rate of tax; how taxable income was computed was apparently ignored. Therefore, the Preliminary Report stated that “*It is not the function of a Convention to provide relief in one State from the effects of a higher level of taxation in the other[;]... for the avoidance of double taxation it should be sufficient if the lower of the two taxes were given up*”. The Final Report (9th September 1960) would not change this perception.

b) The OECD Model today

i) Introduction: justification for focus on the credit method

Since the OECD Model does not specifically address gross taxation, indirect relief, if any, has to be sought in provisions dealing with double taxation. Although the OECD Model offers two alternative methods for mitigating or eliminating double taxation, the following analysis will focus on the credit method for three reasons.

First, both Articles 23-A and 23-B of the OECD Model endorse the credit method for dividends and interest income, precisely the two types of income where gross taxation at source is explicitly vouched for by the OECD Model.

Additionally, and considering a single item of income, it is the only method with the ability to relieve gross taxation at source, in the

event that the net taxation in the residence State exceeds the gross taxation in the source State.

Finally, in the opposite situation, “*if the tax burden in the state of source is higher [quite often the case of gross taxation³⁹], then the credit method works in the same way as the exemption method*”⁴⁰. This means that similar conclusions can be drawn for both methods when gross taxation is at issue.

ii) Limit on the foreign tax credit

When analysing how the OECD Model addresses gross taxation at source, all issues relevant for the elimination or mitigation of double taxation in general, such as conflicts of qualification, conflicts of interpretation, timing of the relief, relevance of source⁴¹, and compliance and formalities, to name a few, are naturally pertinent. However, the specific and therefore main concern as regards gross taxation is how the amount of the relief provided by the residence State is computed. It is therefore essential to ascertain what guidance, if any, the OECD Model provides in this respect.

Disregarding references to taxes on capital, the language establishing the threshold of the amount of credit to be granted by the residence State in respect of tax levied on income in the source State is almost identical in both provisions. Ignoring minor differences of style, the common denominator is the following: “*Such deduction [...] shall not, however, exceed that part of the [...] tax, as computed before the deduction is given, which is attributable [...] to such items of income derived from that other State / to the income which may be taxed in that other State*”. The difference between “*items of income derived from*” and “*income which may be taxed in*” is not particularly relevant since both refer to “*items of income which, in accordance with the provisions of Articles 10 and*

³⁹ See Baker (2009), 23.B10, footnote 3.

⁴⁰ Baker (2009), 23B.01. See also the Commentary on Article 23B, §62.

⁴¹ See Avery Jones *et alia* (1998), pp. 239 ff.

11, may be taxed in the other Contracting State”. The threshold in both provisions can thus be summarised as:

the part of the residence State tax (computed before deducting the credit) attributable to income which may be taxed in the source State.

1. Which measure of taxable income applies

With the exception of timing issues⁴², the tax charge in the source State is in principle known and certain when the limit on foreign tax credit is computed in the residence State. No such degree of certainty applies to the “part of the residence State tax” which is attributable to the income which may be taxed in the source State. More precisely, “*the issue is whether in computing the limit on foreign tax credit one uses the foreign, source country’s measure of taxable income*”⁴³ or that of the residence State. In other words, the latter has to decide whether “*it is going to recognise tax paid on amounts that would not be included in calculating income under its own rules such as where the other country levies a final withholding tax on gross payments*”⁴⁴.

If the source State’s measure of taxable income is used, in principle only a lower tax rate in the residence State may limit the foreign tax credit and at any rate capital export neutrality is achieved. Conversely, if the residence State’s measure of taxable income prevails, differences in its computation may become the major hurdle to the elimination of income tax obstacles to cross-border transactions. Although double taxation may be relieved – if the credit granted prevents the residence State from collecting any tax on the relevant income – gross taxation will remain unaffected, potentially exceeding the profit of the transaction.

⁴² E.g., relating to the date on which the tax liability is assessed in the two States, or subsequent adjustments to the tax liability following a tax audit. See Commentary on Articles 23-A and 23-B, §61.

⁴³ Baker (1998), p. 446.

⁴⁴ Harris (1999), p. 481.

Since gross taxation was not a primary focus of the OECD Model, it is not surprising that it has no clear stance on which measure of taxable income should be adopted for this purpose. At least theoretically, the combination of the expressions “*part of the tax... which is attributable*” and “*income which may be taxed*” might lead to opposing views.

Both the Commentary and international literature consensually maintain that the adoption of the ordinary credit, instead of a full credit⁴⁵, implies that the measure of taxable income of the residence State prevails⁴⁶. Otherwise, in the event the taxpayer derived both foreign and domestic income, the residence States would relinquish some tax on purely domestic income to accommodate a foreign tax credit in excess of their own tax claim “*attributable*” to the foreign income.

This conclusion is disputable. One may argue that limiting the credit to the part of the tax which is attributable to the income taxable in the source State establishes a causal connection, but not necessarily a quantitative correlation. Literally, the “*income which may be taxed*” in the source State is its gross amount, which means one might read that the source State’s measure of taxable income should prevail.

However, the “*part of the [residence State’s] tax*” which is attributable to such income does not appear to be a theoretical amount. Instead, it represents the concrete tax charge that would be due considering the taxable event in its entirety (i.e., both the income and the deductible expenses incurred to generate it). The Commentary on Articles 23-A and 23-B (§62) clarifies the matter by stating that the residence State is not required to give credit for more than the portion of its tax

⁴⁵ See Commentary on Articles 23-A and 23-B, §§16 and 23 ff.

⁴⁶ See Commentary on Articles 23-A and 23-B, §§29 and 63, Baker (2009), 23B10, Holmes (2007), p. 104 (noting that “*inequities arise... because the ordinary tax credit... is typically based on net income*”), Rohatgi (2005), p. 285, and Vogel (1999), also referring to the critical appraisal by some other authors (pp. 1228 and 1229). Baker (1998) also notes that the Commentary does not specifically address scenarios of gross taxation at source (p. 453).

effectively due on the income for which the credit is granted. The Commentary accepts that such income is computed on a net basis.

2. How to apply the measure of taxable income

Several alternatives of application by the residence State of its measure of taxable income are admissible. As an example, there can be a separate computation of the threshold for each item of income but also a calculation of the proportion of the foreign income in the total income, followed by the multiplication of tax due in the residence State by the resulting ratio⁴⁷. In addition, the above computation can refer to a single item of income or to a combination (per country and/or per category, among other possibilities)⁴⁸.

Although these alternatives may give rise to different results and thus greatly impact the position of both taxpayer and residence State, the OECD Model refrains from imposing solutions. According to the Commentary on Articles 23-A and 23-B, the decision was to “*leave each State free to apply its own legislation and technique*” (§62), “[i]n view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax” (§42). This means that States are given generous leeway, provided the basic principle of double taxation relief is observed. However, the practical application of the principle gives rise to numerous problems (e.g., ascertaining where the income is deemed to arise from, allocating expenses between domestic and foreign income, etc.). Consequently, the view that “*The aforementioned problems depend very much on domestic laws and practice, and the solution must, therefore, be left to each State*” (§66; see also §32) is extremely unhelpful.

⁴⁷ The latter assumes the same profit margin for income of all categories and origins. See Commentary on Articles 23-A and 23-B, §62.

⁴⁸ See Commentary on Articles 23-A and 23-B, §64.

Since the relevant concepts of the provision in question (such as “*attributable*” or “*income which may be taxed*”) are not defined, the position of the Commentary in deferring both issues to the domestic laws of residence States may be justifiable in light of Article 3(2). On the other hand, one may also consider remarkable that the OECD Model accepts such reliance on domestic law, considering the impact of such solution on the elimination of double taxation. The Vienna Convention requires that treaties be “*interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*” (Article 31(1)). It has been stated that the context has an additional weight when the tax base is in question, since “*interpretation by recourse to the domestic tax law... is particularly apt to lead to inappropriate results*”⁴⁹. One may thus ask whether the OECD Model should not provide a “*«treaty» meaning of the term[s]*”⁵⁰ in question. A uniform solution for computing the foreign tax credit would at least mitigate the detrimental impact of the “*conceptual misalignment*”⁵¹ between gross taxation at source and computation of the foreign tax credit on a net basis. Such misalignment arises from a “*dislocation between tax law and its subject matter*”⁵², which the OECD Model accepts by tolerating gross taxation.

Notwithstanding the above, refraining from dictating how the foreign tax credit method applies in practice is a coherent consequence of the role and rationale of the OECD Model. The work leading to it focused primarily on the differences between tax rates. Hence, capping the foreign tax credit pursuant to an objective comparison of tax charges befits the purpose of the OECD Model: allocating taxing rights, not ruling (extensively) on how they are exercised.

⁴⁹ Vogel (1999), p. 215.

⁵⁰ Baker (2009), E.20.

⁵¹ Holmes (2007), p. 218.

⁵² Holmes (2001), p. 238.

IV. The response of residence States to gross taxation at source

a) Introduction

According to the OECD Model, the most significant aspects related to the computation of the foreign tax credit fall within the purview of each country. It is therefore necessary to enquire how countries (i) avail of the ample margin of liberty conferred by the OECD Model or (ii) grant unilateral credit in the absence of a DTC, since “*preventing double taxation through a credit or exemption has become part of customary international law*”⁵³. Additionally, Articles 23-A and 23-B are “*altered, supplemented or even replaced wholesale in most bilateral conventions*”⁵⁴ to accommodate specificities of domestic law.

Selecting countries as examples in an international tax law context entails a degree of subjectivity. In this case, the choice is justified as follows. First, an overview of a considerable group (eleven) of OECD countries provides a perspective of what one may describe as a common practice within the organisation. Secondly, three non-OECD countries are also examined in order to try to ascertain whether the practice of the first group is somehow specific to the OECD or denotes a universal trend.

b) Which measure of taxable income applies

i) Examples in legislation of OECD countries

Irrespective of minor technical or language differences, all the eleven OECD countries examined adopt their own measure of taxable income for foreign tax credit purposes (irrespective of the relief being treaty-based or unilateral). Since not a single one of the eleven countries examined was found to dissent, one may venture to assume that they reflect the position in the majority, if not entirety, of

⁵³ Avi-Yonah (2007), p. 133.

⁵⁴ Couzin (2002), p. 267.

the OECD countries in this regard. This may mean that taxpayers resident in economies which represent approximately 50% of the world's gross domestic product⁵⁵ are unable to secure relief against gross taxation abroad⁵⁶:

- Belgium: under the Income Taxes Code (*Code des impôts sur les revenus*), the foreign tax credit (“*Quotité forfaitaire d'impôt étranger*” – Article 285(1)) that may be deducted from the Belgian tax payable is ordinarily capped at fifteen eighty-fifths of the net income (“*quinze quatre-vingt cinquièmes du revenu net*” – Article 286(1)). The amount of the denominator is one hundred, in case the debtor of the income bears the tax levied by the source State on behalf of the Belgian beneficiary of the income (Article 286(4)), which in practice prevents the latter from deriving an additional benefit from gross-up clauses. With respect to interest income, the limit on the foreign tax credit results from a formula which, in very broad terms, takes into consideration the tax effectively suffered abroad, up to a maximum of 15 percent, and the proportion the financial expenses proportionally imputable to the foreign source interest (Article 287(1)(b))⁵⁷;
- France: according to §§19 and 20 of the Statement of Practice no. 14B-1-76, of 1st April 1976 (*Bulletin Officiel de la Direction Générale des Impôts* no. 68, 6th April 1976), the foreign tax credit cannot exceed the part of tax that corresponds to the income to which such credit is attached. For such purpose taxable income is computed as the gross income deducted of all expenses incurred in order to obtain and preserve income, except for the tax suffered abroad (“*est égal au montant brut des revenus diminué*”

⁵⁵ See http://www.oecd.org/document/14/0,3343,en_2649_33959_45467980_1_1_1_1,00.html.

⁵⁶ All non-English excerpts below were unofficially translated by the author.

⁵⁷ See also Schoonvliet (2008), p. 433.

de toutes les dépenses effectuées en vue de l'acquisition et de la conservation des revenus, à l'exception de l'impôt prélevé à l'étranger”);

- Germany: Article 34c(1) ITL, (*Einkommensteuergesetz*) also applicable to companies by virtue of a cross-reference from the CIT Law, states that foreign tax credit is assessed by reference to items of foreign income net of business expenses and negative variations in worth that have an economic connection with the gross revenue underlying such net income (“*Betriebsausgaben und Betriebsvermögensminderungen abzuziehen, die mit den diesen Einkünften zugrunde liegenden Einnahmen in wirtschaftlichem Zusammenhang stehen*”);

- Italy: the former rule (Article 15 ITC) did not clarify whether foreign income should be computed on a gross or net basis for these purposes⁵⁸. The current rule, Article 165(1), sets the cap as the part of the Italian CIT due which corresponds to the proportion of the foreign income in the total income, deducted of tax losses carried forward (“*quota d'imposta corrispondente al rapporto tra i redditi prodotti all'estero ed il reddito complessivo dichiarato al netto delle perdite di precedenti periodi d'imposta*”). Furthermore, if the foreign income is only partially taxable, the foreign tax is also reduced accordingly (Article 165(10)). Except for a few exceptions, such proportion is computed on a per country basis (Article 165(3))⁵⁹.

- Luxembourg: Articles 134^{ter} and 109 (1)1.a of the Income Tax Law (*Loi concernant l'impôt sur le revenu*) clarify that the taxable income underlying the computation of the part of Luxembourg's tax which serves as limit on foreign tax credit (“*fraction d'impôt sur laquelle un impôt à étranger est à imputer*”) is net of expenses

⁵⁸ See Aramini/Franze (2002), p. 30.

⁵⁹ For more details on the Italian regime, see Aramini/Bohicchio (2004), Contrino (2007), and Stesuri/Grammatico (2004).

- incurred to generate it. The relevant part of tax is computed by reference to the proportion of the foreign net income in the total net income (Article 134^{ter}(4));
- Netherlands: Article 36(4) of the Law on the Prevention of Double Taxation (*Besluit voorkoming dubbele belasting*) also clarifies that the foreign tax credit is computed by reference to dividends and interest net of the related costs incurred (“*worden dividenden en interest verminderd met de daarmee verband houdende kosten*”), as is the case of the remaining categories of income under other paragraphs of the same Article;
 - Portugal: according to Article 91(1) of the CIT code (*Código do Imposto sobre o Rendimento das Pessoas Colectivas*), the foreign tax credit is capped at the lower of the tax suffered in the source State and the Portuguese CIT, computed before the credit, due on the income that may be taxed in such State, net of expenses directly or indirectly incurred to generate it (“*fracção do IRC, calculado antes da dedução, correspondente aos rendimentos que no país em causa possam ser tributados, liquidados dos gastos directa ou indirectamente suportados para a sua obtenção*”);
 - Spain: Article 31(1)(b) of the Companies Tax Law (*Ley del Impuesto de Sociedades*) limits the foreign tax credit at the lower of (i) the tax borne abroad and (ii) the tax that would be due in Spain on the relevant income if derived within Spanish territory (“*El importe de la cuota íntegra que en España correspondería pagar por las mencionadas rentas si se hubieran obtenido en territorio español*”).
 - Sweden: pursuant to §10 of the Foreign Tax Credit Act (*Lag 1986:486 om avräkning av utländsk skatt*), the Swedish tax liability that serves as cap of the credit is also computed on the relevant

foreign income after deduction of related costs (“*intäktsposter efter avdrag för kostnadsposter*”);

- UK: s42(3) TIOPA establishes that, for purposes of computing the credit provided under s18(2), income or gain is “*reduced (or extinguished) by any amount allocated to it*” in the form of a general deduction and other specific deductions listed therein. More specifically, in the case of trade income, one must “*take into account (a) deductions which would be allowed in calculating the company’s liability, and (b) expenses of a company connected with the company, so far as reasonably attributable to the income*” (s44(3)). Furthermore, s44(4) states that a “*just and reasonable apportionment of deductions that relate (a) partly to the transaction, arrangement or asset from which the income arises, and (b) partly to other matters*” should be considered.

- US: s904(a) IRC establishes that “*The total amount of the [foreign] credit... shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer’s taxable income from sources without the United States (but not in excess of the taxpayer’s entire taxable income) bears to his entire taxable income for the same taxable year*”. S63(a) states that “*the term “taxable income” means gross income minus the deductions allowed...*”⁶⁰. Additionally, s904(d) contains restrictions for particular categories of income and provisions dealing with overheads and general costs that have to be allocated *pro-rata* to domestic and foreign income⁶¹.

⁶⁰ See Vacovec *et alia* (2001), pp. 401-402.

⁶¹ See also §§359-360 of the US Model Technical Explanation of 15th November 2006. There are various other limitations to the amount of foreign tax credit, some of which with a partial or indirect relationship with the issue of gross taxation at source. Although that was not the issue under analysis, an example is the rule addressed in *Jamieson v Commissioner of Internal Revenue*, US Tax Court docket no. 16421-05, (2009) 11 ITLR 40.

ii) Examples in case-law

The law in some of these countries was not always as clear as currently is (at least apparently) and several interesting points have been discussed before the courts.

1. The *Yates* case

In *Yates v GCA*⁶², among other issues the UK High Court (on appeal from a Special Commissioner decision) had to ascertain the meaning of the expression “*income arising in*” of s498(3) ICTA. This provision read “*Credit for tax paid under the law of the territory outside the United Kingdom and computed by reference to income arising in that territory shall be allowed against any United Kingdom income tax or corporation tax computed by reference to that income...*”. Specifically, the Court had to decide which law was relevant for determining whether income arose, or not, in the source State and it concluded, by a comparative analysis with an equivalent expression in s516(1) ICTA, that where income arose was to be determined by UK law⁶³. Consequently, a portion of the income derived by GCA was deemed to have arisen within the UK and only the foreign tax attributable to the other portion could be credited against UK tax.

With regards to the computation of the taxable income proper, s505 ICTA provided that “*The amount of the credit for foreign tax which, under any arrangements, is to be allowed against corporation tax in respect of any income shall not exceed the corporation tax attributable to that income*”. Historically, in the UK income was measured in accordance with foreign rules, but the opposite position of the tax authorities, upholding that taxable income should be as computed under UK law, prevailed before the

⁶² 1 STC 157.

⁶³ The Court also appealed to a second argument, which, however, was specific to that particular source country (Venezuela), not universal. See the criticism in Oliver (1993), p. 210.

Special Commissioner, despite some uncertainty as to the exact grounds underlying the result⁶⁴. Since this particular point was not argued before the High Court, it was in fact decided by the Special Commissioner alone, with no confirmation from the High Court. Despite the “thin” authority justifying such relevant change, the Inland Revenue Manuals quickly embraced the change and a significant change of practice took effect⁶⁵.

2. The *Legal & General Assurance* case

*Legal & General Assurance Society Ltd v Revenue and Customs Commissioners*⁶⁶ shows how conflicting interpretations can be sustained in respect of the same provision, despite its apparent simplicity⁶⁷. Specifically, and among other issues which are irrelevant for this investigation, the Chancery Division had to decide precisely whether the measure of taxable income in the UK was gross or net for that particular item of income at stake.

The UK tax authorities, appealing from a decision of the Special Commissioners, presented an excerpt of Article 24 of the UK-France DTC as an example of the standard form of the relevant foreign tax credit provision adopted by the UK in its DTCs. The provision read: “*French tax payable under the laws of France and in accordance with this Convention, whether directly or by deduction, on profits, income or chargeable gains from sources within France ... shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the French tax is computed*”. The UK tax authorities submitted that this provision should be construed as requiring a calculation of the portion of the overall profit of the taxpayer that was attributable to the foreign income, because

⁶⁴ See Oliver (1993), p. 215.

⁶⁵ See Baker (1998), pp. 446 and 450-452.

⁶⁶ [2006] STC 1763.

⁶⁷ Hannam (2008) states that “*The judge felt that each party's interpretation of the double tax treaty could be supported*” (p. 462).

that was the “*relevant income*” referred to in s797(1) ICTA. Thus, *Legal & General* (“L&G”) should be allowed credit only against so much of its UK tax liability as was attributable to its foreign income. Otherwise, the taxpayer would be “*given credit against UK tax which is attributable, not to the relevant foreign income, but to other unrelated receipts... [an] anomaly... compounded by the fact that the smaller the amount of the UK tax which is attributable to the foreign income, the more widely the credit relief is spread to the unrelated receipts*” (§30).

Mr. Justice Evans-Lombe noted that Article 24 of the UK-France treaty referred to “*a credit against any [not “the”] United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the French tax is computed...*”. Hence, such expression could be interpreted as simply “*establishing that the foreign income or gain on which the foreign tax arose must enter into the computation of the UK tax against which credit for the foreign tax is claimed*” (§32). Additionally, he also upheld L&G’s view that the wording of the DTC provision and of s790(4) was “*a very circuitous and obscure way for a draftsman who intended to realise the result contended for by the Revenue, to choose to achieve that result*” (§32). Finally, he noted that the position of the tax authorities accorded different meanings to the same expression (income or chargeable gain) in different sections (793 and 795(2)) and that the presence of s798 was more congruous with L&G’s position (§§39 and 40).

Therefore, he concluded that the credit should be limited “*only so that the foreign tax cannot exceed the UK tax which would have been chargeable on that income*” (§42) but that “income” was not so defined under UK law as to impose a separate computation on a net basis for foreign income. Hence, the limit on the foreign tax credit was not the UK tax liability on the particular item of foreign income in question, but the UK tax liability on its relevant worldwide income.

Interestingly, the Irish tax authorities quickly emphasised the absence of any impact of this decision in Ireland. They held in an article on Double Tax Relief that “*The position in Ireland is fundamentally different and has been since the mid 1990s... the net basis is the only basis that was open in Ireland, and this continues to be the case subsequent to the Legal and General decision because of the construction of the Irish legislation*”⁶⁸. Furthermore, even before the decision was issued, the Finance Act 2005 introduced s798A(2), clarifying that “*The reference in section 797(1) to the relevant income or gain shall be treated as referring only to income arising or gains accruing out of the transaction, arrangement or asset in connection with which the credit for foreign tax arises*”⁶⁹. This means that even in the UK this case-law will be of limited relevance in the future.

Nonetheless, the L&G case raises interesting points, including the Court’s view that “*Article 23B of the OECD Model Convention is an example of how the Revenue’s result might have been achieved*” (§32)⁷⁰, implying that according to the Court such provision is clear in requiring the application of the residence State’s measure of taxable income.

3. The Spanish case no. 00/4365/2004, of 15th February 2007⁷¹

A Spanish company rendering technical assistance and management services abroad challenged the position of the Spanish tax courts, which had started to progressively uphold that the cap of the foreign tax credit had to be computed on the net income, as calculated in accordance with Spanish tax law. In its allegations, the taxpayer noted that the computation of the threshold by reference to the net income “*is not based on any explicit legal provision*” (“*no está basada en previsión legal expresa alguna*”).

⁶⁸ Accessed at <http://www.revenue.ie/en/practitioner/tax-briefing/67/tb08.htm> on 10th April 2010.

⁶⁹ s44(2) TIOPA maintains this rule.

⁷⁰ The UK tax authorities also acknowledged that the OECD Model language was clearer (§31).

⁷¹ Accessed at <http://serviciosweb.meh.es/apps/doctrinateac/detalle.asp> on 13th March 2010.

The Court replied that the expression “income”, although not specifically defined for these purposes, relied on the concept of taxable event (“*hecho imponible*”), which in turn was clearly defined as resulting from the adjustment of the commercial profit and loss in accordance with tax rules. Therefore, there was abundant evidence supporting the view that “income” should be understood as the net income, i.e., deducting from the gross foreign revenue the expenses incurred for its generation (“*el rendimiento neto obtenido por dicho concepto, es decir, deduciendo del ingreso procedente del extranjero los gastos necesarios para su obtención*”).

iii) Is the residence State’s measure of taxable income universal?

In light of the above sample analysis of both legislation and case-law, it is appropriate to ask whether the residence State’s measure of taxable income has become universal. It is impossible to carry out such vast enterprise in this paper, but the fact that its application is not exclusive to the OECD can be exemplified with two non-OECD Member States.

In Nigeria, s23(k) CITA exempts from tax dividends, interest, royalties and rental income derived abroad and brought into Nigeria through Government approved channels. However, the credit method applies to other types of income, e.g. profits of a PE or fees which have been liable for withholding tax in the source State. With respect to profits derived in Commonwealth countries, Nigeria preserves the old form of the “*Commonwealth Tax Credit*” once in force in the British Commonwealth. Specifically, s44(2) grants a credit of up to a certain percentage of the “rate of tax”⁷². S44(3) defines it as “*the rate determined by dividing the amount of tax imposed (before the deduction of any double taxation relief granted by this Act) by the amount of total profits of the company for that year, and the Commonwealth rate of tax*

⁷² The Commonwealth rate of tax if it does not exceed half the Nigerian rate of tax and half the Nigerian rate of tax in the opposite scenario.

*shall be determined in a similar manner*⁷³. Although this might in theory give rise to a dilution of the foreign income in the total profits of the company and thus affect the application of Nigerian measure of taxable income, under s44(1) the credit is limited to the product of such rate by “*that part of its profits*” that were subject to tax abroad. With respect to income derived outside the Commonwealth, s46(3) provides that “*The credit shall not exceed the amount which would be produced by computing in accordance with the provisions of the Act the amount of the profits which are liable to both tax and foreign tax and then charging that amount to tax*” at the appropriate rate. Therefore, in both cases the Nigerian rules for computing the taxable profit prevail.

In South Africa, taxpayers deriving foreign income not deemed to be of South African source can avail of the domestic tax relief enshrined in s6quat ITA, be it in the absence of a DTC or instead of the relief provided by such DTC, if they so decide (s6quat(3)). According to s6quat(1B)(a), the foreign tax credit (designated as “rebate”) “*shall not in aggregate exceed an amount which bears to the total normal tax payable the same ratio as the total taxable income attributable to the income, proportional amount, foreign dividend, taxable capital gain or amount, as the case may be, which is included as contemplated in subsection (1), bears to the total taxable income*”. The expression “*total taxable income attributable to the income*” appears more precise than the one adopted by the OECD Model, since it clarifies the need for an intermediate step (re-computing the foreign item of income in question in accordance with South African rules), before ascertaining what the tax payable on the foreign income is. For good measure, Interpretation Note no. 18 (Issue 2), of 31st March 2009, of the South African Revenue Service clarifies that “*In determining the taxable income derived from a foreign source: any expenditure incurred which is directly attributable to such income must be deducted from such income...; and a portion of any general expenses incurred which are not directly attributable to income derived either domestically or abroad, for example,*

⁷³ For profits arising in other countries, see s46(3), where the Nigerian measure of taxable income also prevails.

head office expenses, must be apportioned... based on any method which gives a fair and reasonable apportionment appropriate to the circumstances of the particular case (for example, turnover, gross profit or value of fixed assets)" (p. 23). South Africa's tax base is thus protected: "*The purpose of foreign tax credit relief is not to relieve all foreign taxation thereby subsidising the tax base of foreign jurisdictions, but rather to ensure that in providing relief to South African residents from double taxation, South Africa's tax base is protected*" (p. 22). Nevertheless, although the computation of the foreign income is made on an item by item basis, the rebate itself is computed on an overall basis, thus maximising the amount of credit available⁷⁴. In addition, pursuant to Section 6quat(1B)(a)(iii) any excess can be carried forward for a period of up to seven years.

Notwithstanding the apparent convergence of position between countries with so different tax regimes, the application of the residence State's measure of taxable income is neither unanimous nor even clear in the law of some countries. Actually, in some countries the matter is, or at least was at some point, controversial.

In Brazil, the combined interpretation of Articles 1, 14 and 15 of the Governmental Ruling (*Instrução Normativa*) no. 213/02, of 7th October 2002, appears to indicate that taxpayers are granted a full credit for tax suffered abroad. Specifically, the limit of the foreign tax credit is set at 34% (25% of CIT, plus 9% of social contribution on net profit) of the gross income. The law states that the creditable amount of the tax paid abroad cannot exceed the positive difference between the tax calculated on the taxable profit with and without the inclusion of the profits, income and gains derived abroad⁷⁵. Courts have not explicitly addressed the subject and usually decisions simply state the wording of the Governmental Ruling. In its decision (*acórdão*) of case no. 07-7074, of 2nd December 2005, for instance, the Federal Tax

⁷⁴ Assuming that rules for computing the taxable income are broadly the same in South Africa and in a source country, the foreign tax suffered therein at a rate in excess of the South Africa CIT rate (currently 28%) may still be creditable, as the relevant income may be added to other items of foreign income subject to lower rates.

⁷⁵ "[O] tributo pago no exterior ... não poderá exceder... [a] diferença positiva entre os valores calculados sobre o lucro real com e sem a inclusão dos referidos lucros, rendimentos e ganhos de capital" (Article 14, §11).

Court of Florianópolis referred to the difference between the tax computed with the inclusion of the foreign income and the tax due without that same income, which is almost literally the language of the law⁷⁶.

The above raises the issue of how to interpret the concept of income in this respect. When the law refers simply to the income derived abroad, without any allusion to deductible expenses, the computation of the cap as the positive difference between the tax due with and without the inclusion of foreign income appears to take only into consideration its gross amount. This was precisely the kind of issue that was at stake in Portugal and Spain – two OECD Member-States – for several years, due to the excessive simplicity of the relevant provisions.

In Spain, it is not entirely clear in the wording of the law that the Spanish tax due on the foreign income that serves as threshold of the foreign tax credit implies the computation of such income in accordance with the general rules (including those on deductibility of expenses). Spanish courts have issued conflicting decisions and certain authors held that the cap would have to be computed on the gross amount⁷⁷, thus allowing in practice the source State's measure of taxable income to apply. However, the opposite view eventually prevailed in the jurisprudence, as exemplified above with case no. 00/4365/2004⁷⁸. More recently, Courts have been confronted with (and not yet unanimously solved) the issue of whether a fraction of the general expenses of the company should be proportionally allocated to the relevant foreign income, but the fact that the cap is computed on the net income appears to be settled.

In Portugal, the same conclusion was reached, not by a Court but by act of Parliament. The reference to the Portuguese CIT being computed on income net of expenses directly or indirectly incurred to

⁷⁶ Very similar language was adopted by the Federal Tax Court of São Paulo in the case no. 17-9607, of 12th November 2004. All decisions accessed at <http://deciso.es.fazenda.gov.br> on 27th and 28th April 2010.

⁷⁷ E.g., Zunzunegui/Viñas (2006).

⁷⁸ Another example is the decision of 15th March 2007 (case 00/1922/2004) of the Central Economic and Administrative Court.

generate it was only introduced by Law 39-A/2005, of 29th July 2005. Previously, the wording of the Portuguese law was almost a literal translation of the OECD Model formulation: the cap was simply the Portuguese CIT liability, computed before the credit, corresponding to the income that might be taxed in the source State. Therefore, there was some margin for construing the limit of the foreign tax credit as the Portuguese CIT due on the gross amount of the foreign income, because literally that was the income that might be taxed in the source State. Circular-Letter no. 14825, of 19th March 1997, stated that the tax credit should be computed according to the ordinary imputation method, up to the tax liability calculated in accordance with the Portuguese CIT rules. However, ambiguity persisted, since it was not entirely clear whether the Circular-Letter meant the computation in accordance with the Portuguese CIT rules in respect of the particular item of income derived abroad or in respect of the total income derived by the taxpayer.

Law 39-A/2005 contains no preamble and no preparatory works assist the interpreter in decoding the reasoning of the amendment. In all likelihood, the introduction of an explicit reference to the Portuguese measure of taxable income had a merely interpretative nature. However, the law also repealed the possibility to carry forward (for five years) any excessive foreign tax credit, which may indicate a shift towards a less generous approach to the foreign tax credit mechanism.

If one considered that previously the limit on foreign tax credit was computed on the gross income, the amendment to the law would be deemed to have operated a substantial change in the regime. This would imply a remarkable difference between the Commentary on Articles 23-A(2) and 23-B(1) and the interpretation, by the tax authorities of an OECD Member State, of almost identical language in its own law (the previous drafting of the provision). In the absence of any reservation to the Commentary by Portugal to that effect, and considering the lack of explanation for such a significant change of tax policy, the alternative of a substantial amendment is unlikely.

Nonetheless, one may wonder if Portuguese tax courts will accept that adding the expression “*net of expenses directly or indirectly incurred to generate it*” had merely clarification purposes.

In any case, and even considering the recent evolution of countries like Portugal and Spain, the refusal of a foreign tax credit exceeding the domestic tax due on the relevant net income derived abroad may not be universal and absolute yet. One may only conclude that it is highly likely that such refusal prevails and that the trend should be for it to be progressively adopted by more countries. Even if some countries allow their residents to carry forward or back unused foreign tax credits (or to claim them as an expense deduction), the principle remains that they are not willing to have their tax sovereignty encroached for the benefit of foreign countries. This is precisely the reason why the Commentary anticipates it as the most logical and expected position.

c) How to apply the measure of taxable income

i) General remarks on legislation in OECD countries

Although the limit on foreign tax credit through the application of the domestic measure of taxable income prevails in what appears to be a large majority of countries, the mode of application of such limitation naturally varies between countries. It does not seem possible to discern a common denominator, even amongst the OECD members. A few examples may illustrate this point.

In Belgium, no provision allows excess foreign tax credit to be carried forward, whereas in Italy Article 165(6) ITC allows it to be carried forward for eight years and in the US s904(c) IRC provides for not only a carry forward of ten years but also a carry back of one year. In Luxembourg, any excess is in principle treated as a deductible expense, whereas in Germany Article 34c(2) ITL allows taxpayers to

opt for such deduction instead of a tax credit (the UK also used to allow a deduction instead).

With respect to interest income derived by financial institutions, differences are also significant. In France, for practical reasons, instead of allocating refinancing costs on an individual basis, banks may impute expenses to interest income derived by reference to the balance between interest income and interest expenses for all transactions carried out abroad, thus globalising the limit on foreign tax credit⁷⁹. Additionally, certain overheads are excluded, thus maximising the amount of the credit available (§21 of the Statement of Practice no. 14B-1-76). In the US, s904(d) IRC clarifies that interest arising to banks does not qualify as passive income but instead as general category income (thus preventing the application of some additional restrictions on the amount of the credit). In the UK, however, s49 TIOPA caters for banks and related entities providing that “*notional funding costs*”⁸⁰ prevail over the funding costs effectively incurred (unless these are higher), for purposes of computing the net income arising from a financing transaction.

The list of differences is virtually endless. The above examples serve only the purpose of illustrating that, despite the trend (if not a consensus) within the OECD towards limiting the foreign tax credit by reference to the domestic measure of taxable income, the modes of applying such limit in practice are by no means uniform, as anticipated in the Commentary, and are constantly evolving. As an example, the Education Jobs and Medicaid Assistance Act signed into law on 10th August 2010 amended the US rules on interest expense allocation for foreign tax credit purposes.

⁷⁹ See Gouthière (2010), p. 693.

⁸⁰ I.e., “*funding costs that the relevant bank would incur (on the basis of its average funding costs) in respect of the capital that would be needed to wholly fund the relevant transaction if that transaction were funded in that way*”.

ii) Examples in case-law

In light of the above, it is also not surprising that the courts have also been asked, in some countries, to rule on the modes of application of the measure of taxable income, as exemplified below.

1. The German case no. IR 178 of 1994, of 9th April 1997

In Germany, the issue of the measure of taxable income for foreign tax credit purposes was addressed in the Federal Tax Court case no. IR 178 of 1994⁸¹. Specifically, a German insurance company deriving dividends from several subsidiaries computed its foreign tax credit relief by reference to the gross amount of those dividends. The German tax authorities rejected such computation maintaining that the amount of the dividends should be net of the “*economically attributable business expenditure*” (including interest expense, certain provisions, trade tax and general administrative expenses).

The Court agreed that the domestic measure of taxable income should prevail, i.e., that the cap of the foreign tax credit consisted in the German tax due on the net income, computed in accordance with German law. Specifically, the Court noted that income is “*a general concept which embraces both receipts (net amount) and income (gross amount)*”, thus refusing the idea that “*the treaty meaning of income is to be understood as a net amount*”⁸². However, noting that “*the treaty law... allows the state of residence to regulate... those legal questions which arise in consequence on the amount of foreign tax credits for which credit may be given*”⁸³, it concluded that the threshold of the foreign tax credit consisted in the amount of German CIT due on the taxable income as computed under domestic law.

⁸¹ (1997) 1 OFLR 843.

⁸² At 854.

⁸³ At 855.

On the other hand, the Court disagreed with the tax authorities on how such net income should be assessed. The computation should consider expenses effectively incurred for the purpose of generating the foreign income and not according to a *pro-rata* allocation of all expenses of the taxpayer, in the proportion between foreign and total income. Of all the expenses considered by the tax authorities, only a portion of the general administrative expenses had actually been incurred in generating the foreign income and should therefore be deducted.

This position raises the question of whether, despite the apparently unrestricted leeway, one can discern in Article 23 OECD Model some form of implicit limitation of the ability of residence States to compute the taxable income for foreign tax credit purposes. A purposive interpretation of Article 23 and Commentary appears to authorise the position that a DTC may prevent domestic rules from allocating unrelated expenses to foreign income for purposes of computing the threshold of the foreign tax credit. It is true that §§43 and 62 of the Commentary to Article 23 “leave[s] it free to each state to decide in its own municipal tax law what expenditure may be deducted from income” (at 854-855). However, rules aimed at eliminating or mitigating double taxation on income would be deprived of meaning and consequence if income could be “manipulated”, going beyond the legitimate objective of the residence State protecting its domestic tax base and abusively deprive taxpayers of legitimate relief.

2. The *Commercial Union Assurance* case

In *Commercial Union Assurance Company Plc v Shaw* (CHRVF 98/0348)⁸⁴, the UK Court of Appeal also had to analyse the form of computation of income for purposes of

⁸⁴ 1 ITLR 381, [1999] STC 109.

establishing the foreign tax credit cap. The basic rule was that *“The amount of the credit for foreign tax which under any arrangements is to be allowed against corporation tax in respect of any income or chargeable gain... shall not exceed the corporation tax attributable to the relevant income or gain”* (s797(1) ICTA).

The company, which had borrowed funds to meet the needs of both domestic and foreign businesses, allocated to the foreign income only the interest expense necessary to produce the amount of taxable profit appropriate to the full utilisation of the foreign tax credit. In brief, the company argued that, in accordance with s338(1) ICTA, *“any charges on income paid by the company in the accounting period, so far as paid out of the company's profits brought into charge to corporation tax, shall be allowed as deductions against the total profits for the period as reduced by any other relief from tax, other than group relief”*. In its opinion, foreign tax credit was an example of *“any other relief from tax”*, thus chronologically preceding the deduction of charges. In addition, it recalled that under s797(3)(a) ICTA *“the company may for the purposes of this section allocate the deduction in such amounts and to such of its profits for that period as it thinks fit”*. Accordingly, the company claimed that it could leave a portion of the expense aside (actually allocating it to small chargeable gains and thus available to be carried forward) and use the foreign tax credit in full (at the time, the law did not allow any excess foreign tax credit to be carried forward).

The tax authorities argued, and the Court agreed, that s797(3)(a) ICTA could not be interpreted as allowing charges on income to be disregarded in this context, because the foreign tax credit was not a form of relief from tax which reduced the profits for purposes of s338(1) ICTA, but instead a credit against the UK tax payable. Therefore, expenses should be allocated to the foreign income before claiming foreign tax credit relief. In a certain way, the conclusion is aligned with the decision of the

German case no. IR 178 of 1994 in that expenses should be appropriately allocated to the foreign income, i.e., neither “excessively” (as the German authorities tried to do) nor “insufficiently”, as attempted by Commercial Assurance.

Notwithstanding the above, it has been remarked that, by considering that the power to allocate charges applies only for the purposes of s797 ICTA (“*determining the corporation tax attributable to the relevant income or gain*”⁸⁵), the decision does not clarify the purpose of s797(3) ICTA⁸⁶. Such purpose may be an indirect way of maximising the amount of foreign tax credit, if it is concluded that the threshold is set as the taxpayer’s CIT rate on the foreign income. Specifically, an adequate allocation of charges could increase the CIT rate and thus the foreign tax credit. However, this conclusion would be more fitting if the measure of taxable income of the source country prevailed.

3. The Dutch case no. BD6818, 07/4123, of 27th March 2008⁸⁷

In the Netherlands, much debate and case-law preceded the currently settled position that foreign tax credit is computed by reference to the net income (at least for treaties entered into after 1980)⁸⁸. The current debate focuses on the interpretation of the concept of “related costs” and the Lower Court of Haarlem had the chance of shedding additional light thereupon.

Specifically, it upheld the taxpayer’s position in that the foreign exchange losses arising on the principal of a US\$ loan made by a Dutch company to a related Brazilian company should not be allocated to the respective Brazilian-sourced interest income. The expression “related costs” encompassed only expenses incurred for purposes of generating the income, such as fees and interest paid on funds borrowed to be on-lent.

⁸⁵At 395.

⁸⁶See the Editor’s note, at 383.

⁸⁷Available at <http://jure.nl/bd6816> (accessed on 18th July 2010).

⁸⁸See Specken/Peters (2009), p. 76.

Foreign exchange losses had not been incurred with that purpose (§§4.5-4.8) and should thus be disregarded.

Since then, the Dutch rules have been amended with the purpose of expanding the concept of related costs, primarily to deal with avoidance techniques⁸⁹.

d) Brief remark on the exemption method

As noted above, the exemption method does not provide substantially different answers to the problem of gross taxation at source. At first glance, one might be tempted to say that a difference might be that the solution reached, for instance, in the L&G case, allowing a taxpayer to have its tax liability on domestic income reduced by virtue of taxes paid abroad, could not be replicated in an exemption context.

However, if the allocation of expenses is either ignored or not properly addressed, exempting foreign income may automatically imply that both direct expenses and the portion of general expenses and overheads attributable to such foreign income will effectively offset domestic taxable income, thus reducing the corresponding tax payable. This is precisely why the Commentary on Articles 23-A and 23-B states that “*The amount of income to be exempted from tax by the State of residence is the amount which, but for the Convention, would be subjected to domestic income tax according to the domestic laws governing such tax. It may, therefore, differ from the amount of income subjected to tax by the State of source according to its domestic laws*” (§39) and that “*it is the gross income derived from the State of source less any allowable deductions (specified or proportional) connected with such income which is to be exempted*” (§40). Assuming that this will be the stance of the majority of the countries adopting the exemption method, gross taxation remains to be solved here as well.

⁸⁹ See Specken/Peters (2009), p. 78.

V. The response of taxpayers to gross taxation at source

a) Introduction

As concluded, neither the OECD Model nor the domestic laws of residence States provide an adequate response to gross taxation, since they focus entirely on double taxation. Therefore, in many cases gross taxation becomes “*an absolute tax liability which increases the total worldwide tax bill rather than merely redistributing it*”⁹⁰, a charge that exceeds a reasonable tax on a profit margin, if not the entire margin itself⁹¹.

Therefore, gross taxation (particularly in the form of withholding tax) represents a major hindrance to cross-border investment, as noted in the 1992 Ruding Committee report⁹², even leading to the temptation of setting up a PE to prevent it⁹³. Some authors refer to withholding taxes as being “*often levied on unprofitable activities, hence punishing or distorting cross-border trade and investment*”⁹⁴. Others, when referring to dividend withholding tax, allude to the “*the usual problems of gross basis final taxes at source*” particularly to the fact that “*The foreign tax credit relief in the residence will not be effective if the shareholder... has deductions which reduce the income*”⁹⁵. It is therefore unavoidable that taxpayers themselves respond to gross taxation.

b) Gross-up clauses

In addition to renouncing transactions or engaging in “defensive tax planning”, gross-up clauses are the likely solution for non-resident taxpayers with sufficient leverage over resident counterparties, e.g. some financial institutions and suppliers of intellectual property⁹⁶. The

⁹⁰ Miller/Oats (2006), p. 162.

⁹¹ See Holmes (2007), pp. 104 and 105. See also Baker (1998), p. 453, on the example of GCA, and Commentary on Article 11, §§7.1 ff.

⁹² See Rohatgi (2005), p. 250.

⁹³ See Avery Jones *et alia* (2003), p. 242.

⁹⁴ Cockfield (2002), p. 617.

⁹⁵ Vann (2003), p. 49.

⁹⁶ See CFE Statement, p. 4.

Commentary is aware of this practice, stating that “creditors will, in practice, tend to shift to the debtor the burden of the tax levied by the State of source on the interest and therefore increase the rate of interest charged to the debtor, whose financial burden is then increased by an amount corresponding to the tax payable to the State of source” (Article 11, §7.1).

Assuming that the payer has tax profits and that the grossed-up payment is fully deductible, gross-up clauses are likely to reduce the tax collected by the source State, since the increase in the tax levied on the non-resident should not offset the tax saved by the payer. In all likelihood, the CIT revenue lost on the grossing-up – e.g., 25% or more of 5.26, 11.11 or 17.65 in the example below, with a base payment of 100 – would exceed the increase in tax collected from the non-resident – 0.26, 1.11 or 2.65.

Non-resident reduced rates	Grossed-up payment	Tax due	Net payment
5%	105.26	5.26	100.00
10%	111.11	11.11	100.00
15%	117.65	17.65	100.00

However, with gross-up clauses not only the increase in the tax levied on the non-resident but instead the full tax payable by the latter becomes borne by the resident payer⁹⁷. Accordingly, gross taxation emerges almost as a consumption tax driven by the ability to spend of the payer⁹⁸, instead of an income tax based on the ability to pay of the recipient, which is currently the cornerstone of income taxation in the OECD and modern tax systems in general⁹⁹.

⁹⁷ See Vann (2009), p. 206. Tadmore (2007) argues that gross-up “is likely to be diminished significantly in a treaty context or where foreign tax credits are unilaterally available” (p. 15), but according to the author’s practice suppliers accept at best to share the tax credit, if and once confirmed.

⁹⁸ If unwilling to bear the grossed-up price, the payer will renounce the transaction.

⁹⁹ See Mooij/Stevens (2005), pp. 9 ff. See also Pinto (2007), p. 280, discussing the ability to pay and the distortion caused by gross taxation. Minimising the ability to pay in the international tax order, see Schön (2009), pp.72 ff.

VI. Conclusions and potential solutions

a) Conclusions

i) Gross taxation is more detrimental than double taxation

Gross taxation is not an aggravated form of double taxation; it is an autonomous and more severe obstacle to cross-border income flows than double taxation. Even if the latter is entirely relieved by the residence State, gross taxation remains unaffected, unless the residence State waives some of the tax revenue attributable to other income, which a growing majority of countries seem unwilling to accept.

Gross taxation may be the most significant income tax obstacle to cross-border transactions. Double (net) taxation is a significant hindrance, but does not necessarily render transactions loss-making, as may be the case of gross taxation. Transfer pricing (perhaps the most debated international tax issue throughout the 1990's) has become more of a compliance nuisance than a substantial concern for multinational groups. The allocation of profits to PEs (alive with the new Article 7 OECD Model and related Commentary to become official in September 2010¹⁰⁰) is only relevant where PEs exist. Finally, issues such as triangular situations, conflicts of qualification or the treatment of tax-transparent entities, to list just a few, give rise to more intricate and sophisticated legal issues. However, they arise occasionally, whereas gross taxation is a constant of life.

ii) Gross taxation is a paradox in the international tax framework

Many countries address double taxation unilaterally. Therefore, although relevant, rate reductions and mechanisms for mitigating

¹⁰⁰ See OECD (2010c).

double taxation in DTCs seldom go beyond “improving” domestic rules.

Conversely, where gross taxation is involved, unilateral relief is almost nonexistent. Source States provide insufficient rate reductions and are unwilling to drop gross taxation. Residence States, already enduring the transfer of an excessive share of their residents’ profits to the source State¹⁰¹, usually refuse to “subsidise” the latter with a full credit, since that would incentivise gross taxation¹⁰². The foreign measure of income for computing the foreign tax credit limit is unlikely to gain favour¹⁰³, despite compelling reasoning to that effect¹⁰⁴, since its adoption would aggravate the disparity of efforts in the underlying “*coordination game with a distributive conflict*”¹⁰⁵.

Notwithstanding the absence of proper domestic relief, the OECD Model leaves the matter almost entirely in the hands of domestic law. The Commentary acknowledges that the reduced rates imposed on source States are very often not reduced enough and, at best, Article 23 may be construed as preventing the residence State from imputing unrelated expenses to foreign income when computing the foreign tax credit limit.

Irrespective of the underlying justifications, this represents a paradox in the current international tax framework. Gross taxation can render transactions loss-making (even if a DTC applies), whereas such extreme result only occurs with double taxation if no relief is given in the residence State (for which domestic law is often enough). However, the efforts to remove income tax barriers to cross-border income flows focus on double taxation and neglect gross taxation. Where taxpayers most require protection is where the international tax framework has less to offer, leaving to “defensive tax planning” and gross-up clauses the solution, if any, to what is perhaps the most pressing international tax obstacle to cross-border transactions.

¹⁰¹ See Rixen (2008), p. 166.

¹⁰² See Baker (1998), p. 445.

¹⁰³ A simple example of the likely reasoning of a residence State is provided in Inland Revenue (1999), pp. 21-22.

¹⁰⁴ See Baker (1998), pp. 453-454.

¹⁰⁵ Rixen (2008), p. 161.

b) Potential solutions

i) Towards a net taxation system

If the main purpose of a DTC is to prevent or mitigate double taxation¹⁰⁶, it is not the appropriate instrument for addressing gross taxation. However, if its purpose is more broadly to remove or minimise barriers to cross-border transactions, while at the same time recognising the legitimate claim of source States to tax income arising from the access to their markets, it may accomplish such purpose by promoting a net taxation system¹⁰⁷. One may argue that if the rate in the source State were higher than in the residence State, net taxation should not be significantly different, as the residence State would still be unable to tax the foreign income. However, the impact for taxpayers would be considerable: irrespective of the tax rates at source, a pre-tax profitable transaction would remain a post-tax profitable transaction, often not the case today.

Furthermore, in its First Report, Working Party 11 stated that “*Avoidance of double taxation is no doubt achieved in the interest of the taxpayer and to promote good relations between States... but it entails sacrifices which must be equal if the measures taken are to be acceptable on both sides*”. Where gross taxation is involved, the sacrifice of the source State is more apparent than real (since reduced rates on gross income frequently yield more revenue than standard rates on net income) and the residence State is unlikely to collect any of the tax revenue generated by the transaction.

Certainly, the deduction of expenses of non-resident taxpayers is not simple and is potentially prone to abuse. However, to attach a higher degree of probability to that event if they are incurred by a non-resident taxpayer is unjustified where exchange of information is

¹⁰⁶ In addition to preventing tax evasion, and perhaps double non-taxation (see Baker (2009), B.06-B.10, and the Introduction (§§2 and 3)).

¹⁰⁷ Among various instances, it was already considered by the OECD in the context of e-commerce (see OECD (2004a), §278).

effective, the more so if expenses are incurred in the source State. If they are incurred abroad, the source State may have to rely on the residence State to exercise some control over the taxpayer, but that is already the case today. Although a few countries accept statements from taxpayers themselves, most require from the tax authorities of the residence States the quintessential “condition precedent” for DTCs to apply, i.e., the certification of the taxpayer’s residence¹⁰⁸.

An alternative provision to the OECD Model in accordance with the net taxation principle has already been suggested (Article 17 Commentary, §10) and the precedence of net over gross taxation is at the heart of another (Article 5 Commentary, §42.23)¹⁰⁹. The combination of a refundable withholding tax with the option of filing a tax return for net basis assessment is adopted by some countries for types of income such as capital gains¹¹⁰, and has already been convincingly suggested in the context of e-commerce¹¹¹. Increasing co-operation between tax authorities may extend it to cross-border transactions in general.

In a word, net basis taxation is much more challenging to the capacity of tax authorities but, as correctly remarked, “*countries that accept a UN services PE paragraph in their tax treaties may already have dealt with the gross-net complexity*”¹¹². The introduction of the alternative provision in Article 5 Commentary §42.23 OECD Model may indicate that the OECD Member-States are prepared.

ii) The specific case of interest derived by financial institutions

The impact of gross taxation on financial institutions is particularly severe. Apart from various references and suggestions of modified provisions (e.g., Commentary on Article 11, §7.7), the

¹⁰⁸ A superfluous requirement if proper exchange of information is in place (see OECD (2009b), p. 5).

¹⁰⁹ See Russo (2008), p. 460. Pijl (2008) argues that the source State can tax gross income provided such tax does not exceed the tax assessed on a net basis (p. 473).

¹¹⁰ See Vann (2003), p. 61, footnote 36.

¹¹¹ See Pinto (2002), pp. 207 ff., especially 210.

¹¹² Pijl (2008), p. 473.

OECD noted that “*A financial institution is usually highly leveraged. As a result, a tax imposed on a gross basis will in many cases exceed not only the normal net income tax... but may actually exceed the amount of income earned with respect to the particular transaction*”¹¹³.

In this regard, it has been remarked that in the case of bank interest “*both states accept that the income is business profits*”¹¹⁴ and the OECD appears to share such view. The Commentary on Article 7 states in respect of PEs of financial enterprises that “*making and receiving advances is closely related to the ordinary business of such enterprises*” (§49). It has also been noted that “*business profits may be subject to tax on a gross basis in certain circumstances. This is true, for example, of interest received by banks and other financial institutions... Thus, the current rules... do not appear to be consistent with a conceptually sound measurement of business profits*”¹¹⁵. Accordingly, and alternatively to net taxation¹¹⁶, gross taxation could in this case be addressed by treating interest derived by financial institutions as business income. Such outcome might be achieved either by amending Article 11 or by adopting a new, more purposive, interpretation of Article 7(7)¹¹⁷: where items of income dealt with in other articles represented “business income” proper, Article 7(1) could not be overridden. This would be aligned with the practice of several countries, since “*many States [unilaterally] provide that interest paid to financial institution such as a bank will be exempt from any tax at source*” (Commentary on Article 11, §7.7).

¹¹³ OECD (2004a), §58. See also Article 12 Commentary §8 UN Model, and Schön (2010), pp. 92-94.

¹¹⁴ Avery Jones (2003), p. 245.

¹¹⁵ OECD (2004a), §58.

¹¹⁶ As sustained in Arnold (2003), p. 492.

¹¹⁷ Instead of removing it, as hypothesised in Avery Jones (2003), p. 246. Amending Article 11, defining business profits and deleting Article 7(7) are indicated as potential but unfeasible solutions in Arnold (2003), p. 490.

Either net taxation or taxation as business income would represent the “improvement” on domestic laws that the international tax framework paradoxically fails to provide. Time will tell whether some recent promising signs¹¹⁸ can bring us hope of making progress.

¹¹⁸ The extension of net taxation to passive income in Bulgaria (amendment to CIT Law published in the Official Gazette 95/09, of 1st December 2009) and the Czech Republic (Law 216/2009, of 17th June 2009, published in the Official Gazette on 20th July 2009), although applicable only to EU residents, shows that overcoming the gross taxation paradigm is possible.

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