# Tax Jurisdiction and Tax Relief Mechanism in Tax Treaty:
## The Preference of Source and Resident Country

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**要　旨**

国際税制における課税管轄権は税金の協定の開始とともに長い道のりをたどってきた。所得源泉地国と居住地国における課税管轄権は、今日まで続いている古い問題を生じている。輸入中心の開発国は所得源泉地国における課税管轄権を優先する。その一方で、輸出中心の先進国は居住地国課税を優先する。本研究では課税管轄権に関する問題を明らかにすることを試み、また税金制度の過程でしばしば交渉される部分、税の分類と税率、免税のメカニズムについて述べる。通常、所得源泉地国となる開発途上国は、国内的に投資を奨励するための課税軽減措置を採用する一方で、所得源泉地国における幅広い課税裁量権を確保することを望む。しかしながら、こうしたことは、居住地国政府が、所得免除方式を採用することによってのみ可能となる。さらには、もし、開発途上国が他の国以上に外資を導入しようとすれば、投資奨励策として税率を下げざるをえない。

**Keywords: International Taxation, Jurisdiction to Tax**

## 1　Introduction

As tax treaty between two contracting states is aimed to avoid double taxation or non taxation, it is also followed by an agreement which gives country a right to tax on the same income from foreign resident. Although tax treaty models include tax jurisdiction in its article, the final decision falls into the negotiation of both contracting states. Problems might occur when one contracting state wants to have the tax jurisdiction over some incomes arising in their country from the foreign resident. While, the resident country also claims the tax jurisdiction based on the nationality of the foreign tax payer.

The jurisdiction to tax has long been discussed since the early establishment of tax treaty. This paper tries to discuss the journey of this principle from the 1920's until the latest day of implementation. The main

aim is to examine the appearing problems of tax jurisdiction with regard to developed and developing countries as capital export and capital import country. Accordance with the main topic, the tax relief mechanism used in tax treaty is also discussed. The mechanisms are related with the choice between tax revenue and the incentive level of investment in source and residence country. The two main issues become more important with the increasing numbers of multi national companies combines with the developed and developing countries point of views. While developed countries as capital export countries tend to hold onto the resident jurisdiction, developing countries, as capital import countries, in opposite way try to make the acceptance of source jurisdiction principle in their tax treaties. At the end, based on the analysis and research of the tax jurisdiction and tax relief mechanism, this paper attempts to give some choices for developing country when deals with tax treaty in order to have tax revenue from foreign income and gives the good climate for foreign investment. In other word, it should give the high tax revenue while not discouraging foreign investors.

Tax jurisdiction can be described as the authority of one country to collect taxes including any other taxes related to other matters such as law enforcement of violation of tax laws and resolution of tax disputes. A country’s authority to tax is usually supported by the domestic laws regarding to taxation. Meanwhile, international taxation deals with individuals or corporations income in foreign countries and nonresidents’ income for income in domestic country.

Tax jurisdiction combined with international taxation would result in many conflicts due to the complexity of residential status and cross national transactions. When individuals reside in one country and have the resident status in that country, they must follow the domestic tax rule in that country. There are different definitions in every country concerning the residence. Definition of resident is important in order to determine scope of taxation by one country. Moreover, tax consequences for resident and non resident are also different. For individual, nationality is usually considered to be similar to citizenship. However, except the USA, no other country in the world claims the right to tax its citizens on its foreign income when they live permanently in another country.[1]

The physical presence in one country for an extended period is an important indicator of residence. Some countries also determine residency of an individual by reference to a variety of other indicators of allegiance to the State, such as the location of the individual’s abode, his family, and his fiscal interests. In some countries, physical presence in the State for 183 days in a year is enough to establish residence for that year. Conflicts in residency rules can result in an individual being a dual resident which is a resident of two

different States. Tax treaties generally do an excellent job at resolving problems of double taxation resulting from conflicting residence rules.[2]

Tax convention model from Organization for Economic Cooperation and Development (OECD) model,[3] resident defines as "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof". The United Nation (UN) model[4] has the same definition, except that the UN model is also bundling the resident for corporation in the first paragraph. Another difference from OECD and UN model is the definition of resident for corporation. OECD prefers the location of effective management while UN chooses the place of incorporation to become the resident of corporation.

The various differences between OECD model and UN model are caused by the different situation of the members in those organizations. OECD mostly consists of developed country, which is different with UN whose most of the members are mostly developing countries. Therefore, the purpose of convention is also different, especially from source jurisdiction and resident jurisdiction point of views.

In reality, there are two principles in taxing foreign individuals/corporations for one country. When a country imposes tax based on the source of income in their country, it adopts "source jurisdiction" principle. This principle will give the right to tax all incomes occur in their jurisdiction for resident and non resident. On the contrary, when a country imposes tax based on the residence of individuals/corporations, it applies "residence jurisdiction". Worldwide income of resident will be taxed by the domestic country. Consequently, some conflicts will arise when two different principles are applied for foreign income.[5] This is called double taxation, which is caused by:

- Source-source conflicts.
  It occurs when two or more countries claim tax in their country based on the source principle for one particular income
- Residence-residence conflicts
  Two or more countries claim the same income of a taxpayer because the taxpayer is a resident in their country (dual-resident taxpayer)
- Residence-source conflict
  The same income is claimed by one country because the source of income is in this country and by another country also claims because a taxpayer is a resident in that country.

Double taxation has been defined as the imposition of comparable income taxes by two or more sovereign countries on the same item of income of the same taxable person for the same taxable period.[6] In simple word, double taxation occurs when a resident of one country produces income in another country and subjected to tax by both countries (where he resides and where he earns income). It should be noticed that the conflicts would occur in cases when one country purely adopts one of the principles and deals with other country with the same condition. Since most countries adopt both principles nowadays, among the three conflicts, residence-source is the most likely to happen.

In order to solve the problem of double taxation from international taxation, two countries should conduct tax treaty. For example, when a source country retains its rights to tax a particular flow of income, the country of residence may avoid double taxation on that income in one of two ways; either granting a credit to its resident taxpayers for taxes paid to the foreign jurisdiction or exempting the foreign source income from the taxable income base of its taxpayers.[7]

For international transactions that conducted the same income, it usually comprises of employment or professional income, business income and investment income. The table below shows the summary of how incomes are usually divided in the tax treaty model. The tax treaty models are taken from OECD and UN model.

**Table** 1 . Income Categories in Tax Treaty Model

| Income | Type |
|---|---|
| Employment/ Professional | Employment |
| | Director’s fee |
| | Artistes and Sportsmen |
| | Pension |
| | Government Service |
| Business Income | Business Profit |
| | Immoveable Property |
| Investment Income | Dividend |
| | Interest |
| | Royalty |
| | Capital Gain |

Source: Tax Treaty Model: OECD and UN

The source and residence rule of tax jurisdiction are based on the League of Nations principal in the

beginning of tax treaty era. Despite of the many critics and opponents from the implementation, both principles are still applied in many tax treaties nowadays.

## 2. The Development of Tax Jurisdiction in Tax Treaty Model

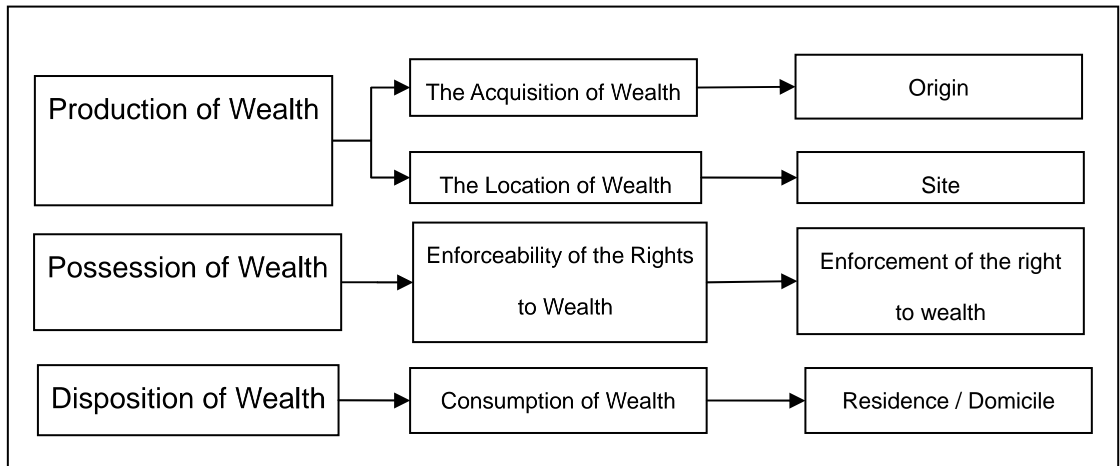
Every individual belongs to a society of a country. In international law rule, the “membership” of individual to a country is called nationality or citizenship. Every nation has its own rules and obligations to their people. The obligations and rights attached to the individual regarding their physical existence to one country is considered as the political allegiance of that individual. A citizen of one country even though he lives in another country, still has the responsibility to his own country. For examples the marriage and the right to vote at an election applied in accordance to the rule of his nationality.

However, for taxation matters, the political allegiance does not necessarily give the sovereign country the right to tax. As stated by experts it in the beginning of 1920’s. In the modern age of international migration of person as well as of capital, political allegiance no longer forms an adequate base for individual fiscal obligation.[8] Therefore, the experts sought for new concept of taxation in international taxation which is called economic allegiance. This concept is based on where the true economic interest of individual is found. Furthermore, in what ways and to what extent can a man be served by two or more governments that in turn oblige him to contribute anything to them?

There are three fundamental considerations of economic allegiance: production of wealth, possession of wealth and disposition of wealth.[9] In the stage of production, it still cannot be regarded as wealth until it has reached a final economic destination, namely disposition. Also, the stage of disposition of wealth has reached its final destination when it comes to the end consumer who would use it in their own ways (waste, reinvest, save, etc). The stage of possession of wealth is the whole tasks of establishing the wealth and preserving it. From this point of view, the experts then added one more thing into consideration and reformed all the considerations to become: the acquisition of the wealth, the location of the wealth, the enforceability of the rights to wealth and the consumption of the wealth. Finally, the four considerations became the corresponding four points in considering the proper place of taxation: origin, site, enforcement of the rights to wealth and residence or domicile.

The whole basic concepts for proper place of taxation by the experts can be seen in the following graph:

**Table 2**. Place of Taxation




Source: Author compilation from the League of Nations, 1923

The experts concluded that all corporeal wealth, including immoveable and moveable tangible, should be assigned principally or wholly to the place of source and all tangible wealth, except mortgage, should be assigned principally or wholly to the place of domicile.

In the following year, Technical Experts to the Financial Committee of the League of Nations submitted a report regarding double taxation and examined the previous report. They preferred source principle for the scheduler or impersonal taxes such as: immoveable property, agricultural, industrial and commercial establishments. On the other hand, for personal or general income tax, it should be levied only by the state of domicile.

In their report and resolutions, the experts divided the double taxation measure into two parts. First part was for impersonal or scheduler taxes and the second part is for personal or general income tax. For scheduler tax, the experts came to the conclusion that only State in which the source of income situated is entitled to impose scheduler taxes.[10] It can be noticed that the 1925 report was more favorable to source-based taxation than the 1923 report.

In its development, the basic concept of origin and site crystallize into the source principle, which requires the taxpayer to pay tax in the country where income is earned. On the contrary, enforcement of the right to wealth and residence crystallize into resident principle, which make taxpayers pay all of the taxes according to the law of their country. Also, starting at Convention Model of League of Nations in 1928, the

source country has the right to tax the business profits attributable to a permanent establishment. During the implementation; however, there are also many pros and contras to the source and domicile principle.

In 1943 The League's Fiscal Committee assembled a regional conference in Mexico City to revise the 1928 convention. In general, the Mexico Draft took the position that the primary jurisdiction to tax income should be assigned to the source country — the position favored by the developing countries. In this respect, the Mexico Draft was a major refinement of the League's 1928 model convention. The basic structure of the 1928 convention, however, remained unchanged.

In 1946, the League's Fiscal Affairs Committee met in London, England, to review the Mexico draft. A new draft (London Draft) was similar in some respects to the Mexico Draft in the treatment of business profits. However, the London Draft also imposed significant limitations on the taxation of investment income in the source country, contrary to the position favored by the developing countries and adopted in the Mexico Draft.[11]

The effort of making tax convention model was then continued by OECD. The OECD published its draft model treaty in 1963 which drew heavily from London Draft. In addition, the first OECD model inserted many features that favored developed countries, as capital exporting countries, over developing countries, as capital importing countries. The final draft was published in 1976. According to Professor McIntyre,[12] the three additional features supported entity isolation. First, the OECD model generally requires the source state to allow a deduction for royalty payments to a foreign company unless the tax authorities can show that the payments constitute some type of fraud transaction or are unreasonable in amount. Second, the OECD model convention prohibits the source state from imposing a withholding tax on the royalty payments. Third, the OECD model has no effective mechanism for preventing treaty shopping. Through treaty shopping, multi national company can move income ostensibly allocated for taxation in the residence country to a tax haven country, with the result that the their income is not taxed either in the source state or the residence state. These three rules, in combination, permit extensive use of what tax specialists refer to as earnings stripping.

In order to further protect their wishes, some developing countries in United Nations tried to make a competitive tax convention model. In 1980, United Nations published the United Nations Model Double Taxation Convention between Developed and Developing Countries. The UN model was based in substantial part on the OECD model, but it departed from the latter model on some key points. In particular, it modified the definition of a Permanent Establishment to allow some additional taxation of business income by the source country, and it provided that any reduction in a country's statutory withholding rates would be done

through bilateral negotiations. The obvious expectation was that treaties based on the UN model would include a positive withholding rate on royalties and that the withholding rates on dividends and interest generally would exceed the rates recommended in the OECD model.[13]

## 3. Jurisdiction to Tax

Jurisdiction to tax can also be categorized as worldwide, territorial and mixed tax system. In a pure worldwide tax system, individual and corporation are taxable on their worldwide income, regardless of where the income is derived. The resident country is usually granting a foreign tax credit to avoid double taxation. In a pure territorial tax system, the country taxes only income derived within its borders, regardless of the residence of the taxpayer. Thus, unlike in a worldwide tax system, foreign source income earned by a resident is exempt from residence-country tax. Nowadays, no country uses a pure worldwide or territorial system. Most countries use mixed tax system in which characterized as predominantly worldwide or territorial, but all systems currently in use share at least some features of both worldwide and territorial approaches.

Another categorization of jurisdiction to tax is with regard to the object of taxation itself. From this point of view, UN and OECD try to categorize them by the type of income and then divided the jurisdiction to tax into two contracting states depending on the income category. The basic idea of the tax convention model is how to allocate the proportional distribution of tax revenue under the same income which may cause conflict for two countries involved and how to define the mechanism to alleviate that conflict.

### 3.1 Jurisdiction to Tax in Tax Convention Model

Commensurate with the spirit of UN and OECD tax convention models, consequently developing countries tend to support the UN model and vise versa. Though UN model basically based on OECD model, there are some adjustments to support the need of capital importing country as the source country. UN model tries to give some room for contracting country to negotiate tax treaty. The different with OECD model can be seen in provision of business profits, dividends, interest, royalties, capital gains and other income (article 21). UN model also still maintain the article 14 on dependent personal services which deleted from the OECD model in 2000.

As seen in Table 1, incomes in tax treaty are categorized in big three groups; employment/professional, business profit and investment income.[14] In this sub chapter, all incomes in tax treaty are discussed from the

jurisdiction to tax point of view. The order of discussion follows the article's order in tax treaty.

Both model treaties start the taxation on income in chapter III and begin with income from immoveable property. Article 6 of the United Nations Model Convention reproduces Article 6 of the OECD Model Convention. Paragraph 1 of Article 6 grants the right to tax income from immovable property to the source country, where the property producing such income is located. This is due to the fact that there is always a very close economic relationship between the source of the income and the State of source. Examples of income from immoveable property in this treaty include agriculture or forestry. This paragraph confirms the source jurisdiction principle.

It is commonly acknowledged that the center of income category is income from business profit; which is written on the next article. The most happening situation in tax treaty between contracting states is income from business profit. OECD and UN models agree that the source country has no right to tax business profit unless permanent establishment (PE) exists. In other word, it can be said that "no PE no tax". PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. Source country is given jurisdiction to tax with conditional statement.

The difference principle of OECD and UN model in this article lies in the treatment of income comes from PE. Under OECD model, the source country has the right to tax only profits attributable to the PE. On the other hand, UN model applies a force of attraction rule, which means that the source country has the right to tax not only income attributable to that PE but also profit from other business in source country other than attributable directly to PE. As most of the UN members are developing countries, it is necessary to give the similar treatment for transactions conducted directly by the home office within the country, but similar in nature to those conducted by the PE. Another clear difference can be found in the text of paragraph 3 of Article 7, which contains rules for allowable deductions. The text in the UN Model is a lot longer than the corresponding provision in the OECD Model.[15]

The next type of income is from shipping, inland waterways transport and air transport. The jurisdiction to tax for this type of income is given to the place of effective management is located; that means resident country. This is the exception of PE concept which usually gives the right to tax for source country. The aim is to ensure that kind of profit is taxable only in one country. Consequently, the profit is wholly exempt from tax at source and taxed exclusively in the country where the effective management takes place. UN model adds alternative in article 8B with respect of international shipping. Different with OECD, the place of effective management of the shipping enterprise is located is the state in which the profits from the shipping

activities are taxable.

In article 9, income from associated enterprises is discussed. It consists of adjustments to profits that may be made for tax purposes where transactions have been entered into between parent and subsidiary companies and companies under common control on other than arm’s length terms. Tax authority of a contracting state may rewrite the accounts of the enterprise if the accounts do not show the right taxable profit in that state with regard to the special relations between the enterprises. As mentioned before, this article is only for profit adjustment in cases when there is a special relationship and has nothing to do with the jurisdiction to tax.

The next item is income from dividend. Although it is mentioned that dividends paid by a company which is resident of a contracting state (source country) to a resident of the other contracting state (resident country) may be taxed in that other state (resident country), paragraph 1 does not prescribe the principle of taxation of dividends either exclusively in the State of the beneficiary’s residence or exclusively in the State of which the company paying the dividends is a resident. Current practice in developing/developed country treaties generally give the right to tax to the state of the beneficiary’s resident. Double taxation is eliminated or reduced through a combination of exemption or tax credit in the residence country and reduced withholding rates in the source country. In paragraph 2, with some limitation, the jurisdiction to tax is also given to the source country (the State of which the company paying the dividends is a resident). The OECD Model Convention restricts the tax in the source country to 5 per cent for direct investment dividends and 15 per cent for portfolio investment dividends, but the United Nations Model Convention leaves these percentages to be established through bilateral negotiations.

Income from interest is taxed in the country of payer, in other word, in the resident country of the payer. Similar with dividend, the source country is given the right to tax with some limitation for the tax rate. The OECD Model Convention provides that the tax in the country of source “shall not exceed 10 per cent of the gross amount of the interest”, but the United Nations Model Convention leaves this percentage to be established through bilateral negotiations.

The jurisdiction to tax for income from royalties is given to the resident country. There is a significant difference between OECD model and UN model regarding royalties. OECD model gives the exclusive right to tax to only the residence country. In a different way, UN model preserves the right to tax in the source country, with the setting of a maximum left withholding rate left to negotiation between treaty partners (paragraph 2 UN Model). This paragraph is also emphasized by paragraph 5 as written “Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State “. Similar with paragraph 2,

paragraph 5 does not appear in OECD model. The definition in the OECD Model only contains of industrial royalties, cultural royalties and know-how, while UN model also defines income from the use of, or the right to use, industrial, commercial or scientific equipment, or in other words leasing income.

The notable difference between the UN Model and the OECD Model with regard to dividend, interest and royalties is that the UN Model does not mention any rates of withholding tax. These rates should be established through bilateral negotiations. The second difference is that the UN Model grants in article 12 a limited taxation right to the source state with respect to royalty payments. On the other hand, under article 12 of the OECD Model royalty payments are taxable only in the residence state of the recipient of the royalties. The definition of royalties in both models is also different.[16]

Under Article 13 of OECD model and UN model, gains from immoveable property are taxable in the country where property is located (source jurisdiction). Gains from the alienation of moveable property are taxable in the country where the PE is located, which corresponds to the rules for business profit. UN model inserted two paragraphs from OECD model. UN model allows a Contracting State to tax a gain on an alienation of shares of a company or on an alienation of interests in other entities the property of which consists principally of immovable property situated in that State. It is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of such property, it is necessary to tax the sale of shares in such a company.

The next types of income are the classes of income and capital that may be taxed without any limitation in the source country:

- remuneration in respect of an employment in the private sector, exercised in that State, unless the employee is present therein for a period not exceeding 183 days in any twelve month period commencing or ending in the fiscal year concerned and certain conditions are met; and remuneration in respect of an employment exercised aboard a ship or aircraft operated internationally or aboard a boat, if the place of effective management of the enterprise is situated in that State;
- Directors' fees paid by a company that is a resident of that State. UN model added one paragraph which decided that where a top-level managerial position of a company resident in a Contracting State is occupied by a resident of the other Contracting State, the remuneration paid to that official should be subject to the same principle as directors' fees;
- income from the activities of artistes and sportsmen (UN model changes the word into "sportsperson") exercised in that State, irrespective of whether such income accrues to the artiste or

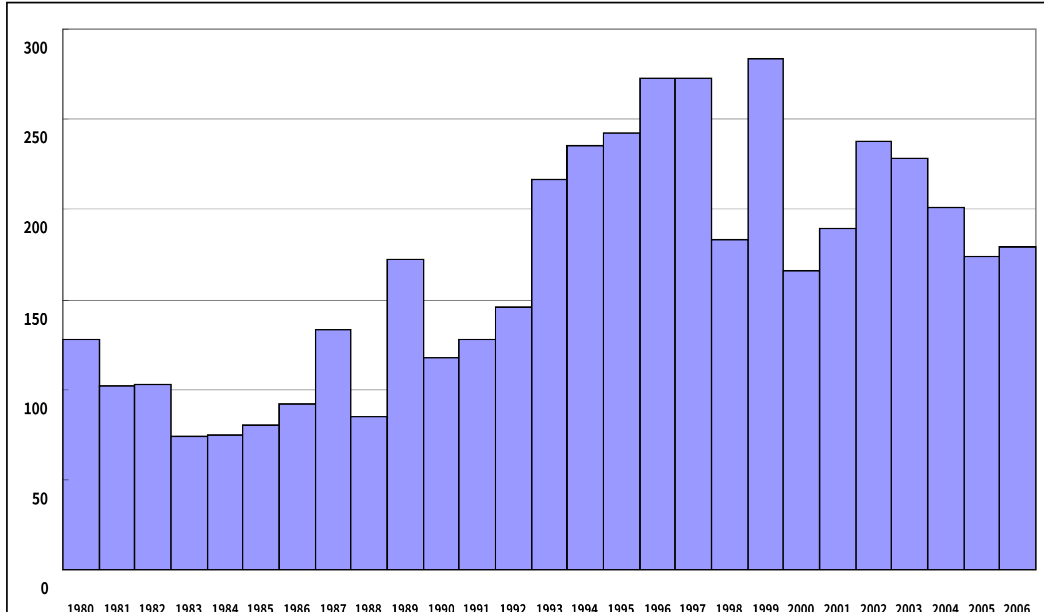
sportsman himself or to another person;

- subject to certain conditions, remuneration and pensions paid in respect of government service

Other items of income or capital may not be taxed in the source country; as a rule they are taxable only in the State of residence of the taxpayer. This applies, private sector pensions, payments received by a student for the purposes of his education or training. However, UN model gives alternatives to provide for a sharing between the country of residence and the country of source of the right to tax pensions and other similar remuneration when the payments involved are not made within the framework of a public scheme which is part of the social security system of a State or a political subdivision or a local authority.

Regardless the difference between UN model and OECD model tax treaty as the tools to avoid double taxation has been implemented in many countries for many years. As developed aim to protect their tax collection in the residence country, tax treaties are mostly done by developed country. Based on data from United Nations,[17] there have been more than 4500 tax treaties from 1980 until 2006. The table below shows the development year by year:

**Table 3**. The Number of Tax Treaty Worldwide




Source: United Nations, “World Investment Report: Transnational Corporations, Extractive Industries and Development”, 2007.

### 3.2 Capital Importing Country and Capital Exporting Country

Source taxation is usually preferred by the capital import country, the place where many foreign investors spend their capital for investment. This capital import country is typically the developing country where labor and other resources are cheap and try to attract many investors from abroad. However, it is not easy to adopt the source taxation for developing country. In one hand they want to raise revenue by taxing capital from foreign investment, but on the other hand they need to attract foreign capital to have investment in their country.

On the contrary, capital export country is the country whose citizens spend their capital in foreign country, mostly developed country. When the competitions are tough, the basic resources for production are expensive and followed by the high rate of tax, the capitalists will try to find the alternative place for their investment. That is why a lot of multi national companies move and spend their investment in developing countries will give lower production cost. The form of capital exported is not always in cash capital such as foreign direct investment but also portfolio capital in the foreign stock market. Therefore, capital export country prefers residence country.

From capital export countries and capital import countries approach, it needs international tax neutrality in order to have the neutral solutions. The principle of tax neutrality requires that any equitable tax system treat economically similar income.[18] The two approaches need to have capital export neutrality and capital import neutrality. Under the capital export neutrality approach, income derived from international transactions should be similarly taxed as income derived from domestic business. There are two ways to make this approach possible. The first is to give foreign tax credit. The resident country may tax the worldwide income and in addition give permission to credit the foreign tax which is paid in foreign countries. The second way is to give tax exemption for foreign income. From both approaches, if the sales are conducted in the country without permanent establishment, the tax is not exempted in the importing country. In case of the exporting country is also subject to tax in the importing country, because it has permanent establishment, capital export neutrality is achieved through foreign tax credit.[19]

Meanwhile, the aim of capital import neutrality is to make fair competition within the market of the source country. In this approach, every income is subjected to be treated as the same tax burden. Either the nationality of the seller or place of production should be indifferent. There are also two ways to achieve this neutrality. The first is that the source country should tax business income generated in source country and gives tax credit for foreign income. The other way is to tax in source country and gives exemption for income

conducted abroad, including in resident country.

In reality, capital import neutrality is enforced through an exemption approach, like the French regime of territoriality. However, countries who apply capital export neutrality, usually do not apply the principle completely. A tax system respecting capital-export neutrality should have two provisions in the case of a local company that invests abroad and thus is subject to foreign taxes.[20]

As mentioned before, international tax regimes mostly use two models in making tax treaty to avoid double taxation, UN model and OECD model. UN model is more favorable for developing countries and on contrary; OECD model is supported by developed countries. The difference is caused by two underlying concept of OECD, which are: the resident country try to eliminate double taxation by giving foreign tax credit or giving exemption for foreign income from tax, which makes source country reduce both: scope of its jurisdiction to tax at source and also the rates of tax where jurisdiction is retained.[21]

On the other hand, developing countries expect more from tax treaties rather than to avoid double taxation. They hope that tax treaty would also include provisions which go beyond tax credit or exemption method by providing affirmative incentives or assistance to investment in their countries by residents of developed countries; such as special deduction or tax credit granted by developed country for investment in developing countries.[22] In OECD model, the way to eliminate double taxation is often done by requiring the source country to give up some or all its tax on certain categories of income earned by resident of the other treaty country. This kind of treaty is suitable only if the flow of investment is similar. If the developing countries; which are most of them capital importer country, use the exemption method for granting double taxation relief with developed country, it would not give any advantage from the tradeoff of source jurisdiction for resident jurisdiction contained in OECD model.

As examples above mentioned, OECD model gives the limited taxation to the source country for dividend (5 percent) and interest (10 percent). Some other incomes can not be taxed in the source country; such as: royalties (article 12), gains from alienation of shares or securities (paragraph 4 of article 12) and payments received by a student for the purpose of his education or training (article 20). Business profits that are not attributable to a permanent establishment in the source country are taxable only in residence country.[23]

OECD itself in 1965 admitted that OECD tax convention model might not have been appropriate for developing countries.[24] At that time income flows are largely from developing countries to developed countries. By using a residence based treaty the country of source would be required to give up tax revenue. If the term had been current then the model might even have been considered harmful to developing countries.

The OECD at that time acknowledged that the principles on which the OECD Model was based were more suited to developed countries. While countries choose to use the OECD Model, the OECD in this initiative seems intent on determining the fiscal policy of selected countries. This conflict between developed country and developing country is the reflection of source jurisdiction and resident jurisdiction

## 4. The Source and Residence Country

The double taxation in tax treaty is relieved by three mechanisms which one of them is usually chosen by the contracting states through negotiation. The first one is deduction method. By this mechanism, the residence country allows its taxpayers to claim a deduction for taxes that has been paid to foreign countries for foreign source income. By this way, foreign taxes are treated the same as current expenses of doing business or earning income in the foreign jurisdiction. The second one is exemption method in which the residence country gives its taxpayers with an exemption for world wide income. In other word, only the source jurisdiction country has the right to tax that income. The third one is credit method. In this method, the residence country provides its taxpayers with a credit against taxes otherwise payable for income taxes paid to a foreign country. If foreign tax rate is less than the domestic rate, foreign source income is subject to domestic tax. In addition, the residence country will not pay tax refund when their taxpayers pay a foreign income tax at higher rate than domestic effective tax rate.[25]

However, in reality, although the exemption method is mentioned in OECD and UN model, a full exemption method is difficult to justify and is used by few countries only.[26] The logic behind is because exemption method offends against the tax policy objectives of fairness and economic efficiency. This method can encourage resident taxpayers to invest abroad in countries with lower tax rates; such as tax haven country, and it encourage them to divert domestic source income to such countries.

An example to illustrate the difference between three mechanisms is given in the following example. A Corp in country A earns 1000 US$ as income in country B. Income tax rate for corporation in country B is 30 percent. In resident country, A corp. is taxable corporation at a rate of 40 percent. If country A applies deduction method, A corp. will pay domestic tax for the net foreign income of 700 (1000 – 300). It means A corp. must pay 280 domestic income for foreign source income in country A. The total tax paid is 580 (280 + 300). If country A uses exemption method, A corp. will be exempted of their foreign source income. The foreign source income of A corp. only will be paid in country B, as much as 300. No domestic tax for foreign

source income under the exemption method. Under the credit method, the foreign tax paid in country B is creditable in country A. As the tax rate is 40 percent, A corp. must pay 400 for their foreign income. However, since the tax paid in country B (300) is creditable, A corp. only has to pay 100 (400-300). The following table will summarize the example:

**Table 5**. Relief Method

| | Deduction Method | Exemption Method | Credit Method |
|---|---|---|---|
| Foreign Income (Source country) | 1.000 | 1.000 | 1.000 |
| Tax in Source Country (30%) | 300 | 300 | 300 |
| Deduction for Foreign Tax | 300 | 0 | 0 |
| Net Domestic Income (Resident Country) | 700 | 0 | 1.000 |
| Tax Before Credit in Resident Country (40%) | 280 | 0 | 400 |
| Tax Credit (Resident Country) | 0 | 0 | 300 |
| Total Tax Received by Resident Country | 280 | 0 | 100 |
| Total Tax paid by A Corp | 580 | 300 | 400 |

Source: Compiled by Author

As seen from the table, under the deduction method, taxpayers in resident country will not only pay the highest income tax, but will also pay higher than effective domestic income tax rate. Since the deduction method is the least generous method, only few countries apply this mechanism and it is not mentioned as the relief method in OECD and UN tax convention model. Only exemption method and credit method are mentioned in both models. However, both methods are also not entirely free from disadvantage. Under the exemption method, the taxpayers in resident country where tax rate higher than foreign country can easily move their business to a lower tax rates country. This is especially true when it comes to the tax haven country. From the table above, A corp. must pay taxes in both countries and will pay the highest total tax if resident country apply deduction method. From the tax authority point of view, exemption method is the easiest way to implement. Only one country imposes tax.

## 4.1 Preference of Source Country

Capital importing country needs to attract investment as many as possible. If necessary, tax holiday is

given to the investors. However, a tax incentive is useless if the resident country imposes tax for the same income is the source country. The table bellow shows the level of incentive for cross border investment from the combination of method and taxation in both countries: [27]

**Table 6**.　Incentive Level for Cross Border Investment

| Number | Residence Country | Host Country | Level of incentive for Cross-border investment | Who collects? |
|---|---|---|---|---|
| 1 | Exemption | No Tax | High Incentive | None |
| 2 | Credit | No Tax | Moderate | Residence |
| 3 | Deduction | No Tax | Moderate | Residence |
| 4 | Exemption | Tax | Moderate | Host |
| 5 | Credit | Tax | Moderate | Host |
| 6 | Deduction | Tax | Low Incentive | Both |
| 7 | No Alleviation | Tax | Lowest Incentive | Both |

Source: Tsilly Dagan “Tax Treaty Myth”, NYU Journal of International Law and Politic Journal Vol. 32, NYU, 2000.

This table will provide a clear image of source country preference. High incentives of investment will be created only if no taxation at all in both countries. It is not enough for the host country to exempt its foreign investors; rather, their country of residence should exempt them as well. To obtain the high incentive condition (number 1 in Table 6) to a certain extent is impossible. Even if the source country gives full tax holiday to foreign investor, it needs the reciprocal treatment from the resident country. Finally, there will be no country imposing tax and no taxes were imposed to the investors. With the assumption that residence country will also not impose tax, there is another point that needs to be considered in order to achieve high incentive. That is interest rate. The investment in the source country will be made as long as the income before tax is at least as high as the market interest rate determine in world capital market[28] (the opportunity cost of investing in the source country). In the presence of tax, these investors require a *higher* before-tax return to continue investing in the host country because of the increased.

If source country gives tax incentives but residence country imposes tax either by tax deduction (number 3 in Table 6) or credit (number 2 in Table 6), it will create only a moderate incentive for cross-border investment. In fact, the source country will get no revenue at all from income conducted in their country. This

condition is not suitable for the source country from the tax point of view. Even if large investment is made, no taxation is collected in the source country. These two options are applied in tax haven country which gives high incentive for the investors in developed country. However, many tax authorities and international tax communities are against it.

Another option for source country to have a high incentive is to perform “tax sparing” with their tax treaty partners. Tax sparing is a credit granted by residence country with respect to tax from source countries that have not actually been paid. A simple example of tax sparring is illustrated as followed. Two countries, country A (developed country) and country B (developing country) agree to impose withholding tax rate of 10 percent on interest. In order to attract as many investors as possible, country B gives tax incentives for withholding tax on interest at 5 percent. In tax treaty, Country A grant their resident a foreign tax credit equal to the amount of tax paid by A resident to country B in respect of withholding tax on the interest. In tax sparing provision, the treaty also provides that the tax paid on interest shall always be deemed to be equal to 10 percent of the gross amount of the interest. Tax rate in country A is 40 percent. A Co, a corporation in country A, gets an interest payment of 1000 in country B. With tax sparing provision, A Co pays 50 (5 percent of 1000) for interest tax in country B but gets the tax credit of 100 in country A. It means that A Co pays only 300 to country A as the foreign source income is 10 percent creditable. With the absence of tax sparing, A Co must pay 350 to country A. In other word, A Co gets additional 50 tax credit for the tax that actually is not paid.

Without tax sparing, the tax incentive given by capital import country to attract investment will be ineffective. The actual benefit of tax incentive will go to the residence country rather than the foreign investors. As in example above, without tax sparing provision, the 50 incentive will be taken by country A. However, there are many objections to tax sparing, especially from developed countries. One of the reasons is that tax sparing contrary to the capital export neutrality. In their report, OECD suggests that the case for tax sparing is not persuasive. It recommends that tax sparing be restricted to countries whose economic development is at considerably lower level than of OECD member countries.

As not many options can be chosen by capital importing country, condition number 5 in Table 6 is the best preference. Tax credit from residence country combined with tax in source country would give better solution. Effective tax rate in tax treaty should be negotiated to achieve the ideal environment of investment. That is from the capital investment point of view. If ideal condition can not be reach, source country would be better to have more tax objects to be collected in their country.

On the contrary, there are a few capital-importing countries that willing to give up their tax revenues and attract more investment through lower level of tax rate or even giving tax exemption for resident. Hong Kong is the prominent successful story of exemption method. Other countries, like Azerbaijan, Bolivia, Kazakhstan, Bahrain and Chile, attract FDI to exploit rich natural resources that are a main source of income. Corporate income tax rates and withholding taxes earned from oil or mining production tend to be high and the governments rely less on special preferences like tax holidays and special financing regimes.[29]

The choice between taxing income and attracting investors is a dilemma. The best choice for capital importing country is the policy that gives the high tax revenue while not discouraging foreign investors.

### 4.2 Preference of Residence Country

Developed countries as capital exporting country; and also usually residence country, mainly concern about two points, which are outbound investment and state tax revenue. Those two points combined with the degree of incentives from the capital exporting countries, it can be described in the following table:

**Table 7**. Incentive Level for Capital Exporting Country

| Relief Mechanism | Level of Incentive for Outbound Investment | Tax Revenue |
| --- | --- | --- |
| Exemption | High | None |
| Tax Credit | Medium | None |
| Deduction | Low | High |

Source: Compiled by Author

The first condition shows that resident country prefers to give a high incentive for outbound investment and willing to give up tax revenue from the residence doing business in foreign countries. In this condition, the residence country believes that outbound investment would give more benefit than imposing tax on it. Residence countries; which adopt this policy by exempting their residents from taxes on outbound investments, would enjoy a competitive advantage over residence countries that do not adopt such a policy.[30] Exemption mechanism in the residence country would realize the capital import neutrality condition.

Under the tax credit mechanism, residence country will only give moderate level of outbound investment and do not want to give up all tax revenue from their taxpayers conducted business abroad. This circumstance corresponds with capital export neutrality. As mentioned before, usually the residence country gives a

limitation on tax creditable to the level of the residence country taxes. If the effective tax rate in source country is the same with residence country, then all taxes would be collected in the source country.

The deduction mechanism gives the lowest incentive for outbound investment. Residence country prefers to collect tax revenue as much as possible from the foreign income of their taxpayers. Under this relief mechanism, multi national companies would pay at a higher level compared to other relief mechanism in tax treaty. As in case example from Table 5, A corp. would have to pay 580 compared to only 300 from in exemption method and 400 in credit method. By international tax practitioners, this mechanism is called national neutrality which gives the maximum tax revenue for the residence country and also source country at the same income.

From the three preferences, the application of relief mechanism depends on the residence countries' aim on level of outbound investment and also collection of tax revenue. However, it should be noticed that if deduction method is applied, the multi national company would pay a higher level of tax in both countries.

## 4.3 Choices for Developing Country

Developing country usually in the position of capital importing country and becomes the source country in tax treaty. Capital importing country means that developing country mostly gets the benefit from foreign investment especially from multi national companies. As the source country for foreign investment, the physical infrastructure, political stability and law / legal certainty are inevitability needed to be preserved in order to keep the stable foreign investment. All those efforts to give the favorable climate for investment consequently require some expenses for source country's government. This is the prominent reason for claiming the tax for source country. Based on the preference of source and residence country in the previous chapter, there are some choices for developing country dealing with international transaction.

From both tax treaty models, UN model is the best tax treaty model that can be used for developing country. From this model, the tax rate from foreign income in dividend, interest and royalties could be established through bilateral negotiations between contracting states. Another advantage from UN model is the right to tax in the source country from royalties income where the exclusive the right to tax is given to the resident country in OECD model.

Tax relief mechanisms that can be chosen from the model are exemption and tax credit system. Before enter into tax treaty negotiation, developing country should seek the preference of that country, especially if the opponent country is developed country. If the characteristic of developed country is the country that gives

high incentive for outbound investment, then exemption method is the best preference for tax relief mechanism. This condition is an ideal for developing country as the source country for foreign investment. When this condition is reached, developing country can make negotiation for tax rate in tax treaty to promote more incentive for investment in their country. As long as there is no taxation in residence country, there is a possibility to negotiate the lower tax rate in tax treaty so that more investment could be attracted.

The second option is tax sparing mechanism. As explained before, tax sparing will give incentive for foreign investor. The problem is that not all developed countries support the system. The tax treaty negotiator from developing country should have the ability to convince their treaty partner about the true intention of their country to increase the foreign investment.

If the treaty partner's preference gives medium incentive for outbound investment, then developing country could choose the credit method for tax relief mechanism. Tax credit system gives only an average advantage for foreign investment. There are many other considerations rather than only the tax credit mechanism. In order to attract more investment, developing country could make a special treatment outside tax treaty such as tax incentive for particular business in limited time or free trade zone in specific area.

## 5　Conclusion

The long journey of tax treaty creates the same old problem, the jurisdiction to tax between source and residence country. In 1945, a scholar stated that capital exporting country with large investment abroad generally favored the principle of residence because this principle least restricts the exercise of their power to tax income derived from foreign investment. Meanwhile, capital importing country had contended that the state where the investments are made and from which the income is derived should be given some jurisdiction to tax, if only because foreign investors have enjoyed the protection of its laws. In other word, capital importing country supports the source principle.[31] This statement and condition, which made in 1945, still exist until the recently. From the beginning of 1920 until the last version of tax treaty model, the discussion of tax treaty is centralized by the debate of which country has the right to tax the foreign income.

UN and OECD tax convention model are slightly different in the favoring of source and residence country of taxation. As the members of OECD country are mostly developed country, OECD model gives more preference to the residence jurisdiction to tax. On the contrary, UN model supports the source jurisdiction which is more favored by developing countries. Nonetheless, the final decision of tax treaties is in

the hand of both contracting states based on the preceding negotiation. In practice, there are more than 4.000 tax treaties that have been signed in order to alleviate double taxation.

In search of the best condition for the relief mechanism, achieving both high tax revenue and in the same time high incentive for inbound/outbound investment is absolutely impossible. A country should have a willingness to exchange their tax revenue with the incentive of investment or vice versa. The needs of source country for having high tax revenue and in addition giving the high level of incentive of inbound investment will be achieved only if the residence country applies exemption method. On the other hand, the source country should not impose high tax for the foreign company if they want to compete with other source countries. The lower tax rate of source country will make a higher incentive of inbound investment. This method would not give tax revenue for residence country. Therefore, the ideal purpose is not fulfilled according the residence country point of view.

In the case of tax exemption could not be attained, developing country should choose tax credit as the second option. By granting tax credit in the residence country, investor would have a moderate level of incentive to invest abroad. Another way to promote inbound investment for source country is to negotiate with residence country for the tax sparing in which the source country will get benefit from the lower tax on foreign company. Tax sparing could be done under the tax credit mechanism. The residence country allows tax credit for the tax that has actually not been paid in the source country.

Giving the fact that source country could not impose the high tax rate to attract foreign investment, only both mechanism works for inbound investment. If deduction method is applied by source country, multi national company will be burdened by heavy tax in both source and residence country.

Before enter into tax treaties, developing country should carefully take a depth-look at the characteristic of its treaty partner. It is important to know how multi national companies in treaty partner do the business and what kind of income usually reached by those business. With the knowledge of that characteristic, developing country could have the right path to give encouragement for foreign investment and at the same time receive the suitable tax revenue.

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