INTERNATIONAL TAXATION

INTRODUCTION

What is international Taxation

- refers to the global tax rules that apply to transactions between two or more countries (also called States) in the world.
- It encompasses all tax issues arising under a country's income tax laws that include some foreign element.
- International law consists of customary international law and international agreements. It covers rights of a state to tax, tax treaties and dispute settlement.

International Taxation

- International taxation governs these domestic tax rules under customary international law and treaties.
- International taxation also supports other objectives of domestic tax systems.
- What are some of the objectives?

Objectives of Domestic Tax Systems

i. to promote fairness by imposing equal tax burdens on domestic and foreign taxpayers with equal income and ability to pay, regardless of the source of the income;

ii. to enhance domestic competitiveness through fiscal measures and to promote economic growth;

iii. to obtain a fair share of the revenues from cross-border transactions; and

iv. to ensure an equitable balance between capital export and capital import neutrality.

Sources of International Tax Law

1. Domestic Law

- The *charge to tax* is inevitably found in the domestic law of each state.
- In Kenya, the charge to direct taxation is typically found in the annual Finance Act
- The Finance Act also sets the rates at which tax is charged.
- If a matter is not regulated by other sources of law, or if there are no other sources, then domestic law applies.

Sources – Domestic Law

- This means that the domestic law specifies when and in what manner a domestic charge arises with respect to a cross-border dealing.
- DL identifies relevant factors that bring a transaction or dealing within the charge to tax, often called ‘connecting factors’.
- DL also specifies any special considerations in calculating the charge to tax on a cross-border dealing.

Sources

- Domestic law specifies how the domestic charge is to interact with any charge imposed by a foreign country e.g foreign tax relief.

2. Tax Treaties

- The domestic direct tax laws of countries involve the unilateral exercise of sovereignty, and so they do not coordinate/integrate very easily.
- Tax treaties aim to better coordinate laws, removing potential double taxation, thereby freeing up international trade.

Sources – Tax Treaties

- Tax treaties are, s.t. limited exceptions, bilateral in nature.
- They draw their status from domestic law.
- Are essentially a bilateral agreement as to how 2 states agree to divide taxation of cross-border dealings between them.
- Their principal purpose is to provide relief from double taxation as between two states. Hence are termed 'double tax treaties', 'double tax conventions' or 'double tax agreements'.

Sources – Tax Treaties

- In recent years, a supplementary purpose of preventing fiscal evasion.
- Treaties allocate taxing rights between the two states and taxpayers derive their rights from this allocation.
- Tax treaties and model treaties are built on political compromise. They are comparatively short, their language is often difficult (and explained only by historic precedent) and are far from comprehensive.
- They simply do not deal with all tax issues that arise from international dealings.

International Taxation

- Subject of int'l tax – whether and to what extent a country has the right to tax an individual or a company i.e. its jurisdiction to tax.
- A lot of the complexity in current tax systems stems from the need to interact with other tax systems in a global environment.
- The different tax systems create opportunities for taxpayers and scope to play one tax system off against another in order to minimise worldwide tax burden.

Jurisdiction to Tax

- Is the right of a country to levy tax on a person/company.
- What determines that right?
- For a tax liability to arise, there must be a taxable event on which a State can exercise its taxing rights, and there must be a person who is liable to pay the tax.
- Moreover, the two must have some connection with the taxing jurisdiction to be subject to its tax law .

Components of a taxable transaction

1. **Tax Subject**

natural person or a legal person.

2. **Tax object**

What tax can be computed on

3. **Connecting factor**

"reasonable connection" between the taxing powers of the State, and the taxpayer or the transaction.

Jurisdiction to Tax

- Most countries use the principles of source and residence.
- The concept of tax residence is often quite different from the concept of residence for other purposes.

Jurisdiction to Tax

1. **Residence** – country reserves the right to tax its residents on their worldwide income and gains.
2. **Source** – Country reserves the right to tax not only the worldwide income and gains of its tax residents, but also the income of non-residents arising within its borders.

- Int'l tax issues arise when a person is resident in one country and has the right to income arising in another country.

Jurisdiction to Tax

- Therefore the 2 countries may have to come to an agreement which has the right to tax.
- Tax treaties aim to define which country a TP will be considered to be resident for tax purposes and how different types of income and capital are to be divided.
- The OECD produced a Model Double Tax Convention in 1963.

Principles of international taxation

- The principles of international taxation are influenced by tax equity and tax neutrality.

i. Tax equity requires that the tax revenues from international economic activities be shared equitably by nations.

ii. It also requires that taxpayers involved in cross-border activities be neither discriminated against nor given undue preference in their tax burdens.

- Tax systems are neutral when they do not influence the economic choices of taxpayers.

2 Notions of Neutrality

1. **Capital Export Neutrality (CEN)** – Concerned with neutrality in the location of investment.

- Tax system should be designed so that it is neutral regarding outflows of capital so that the total of domestic and foreign taxes doesn't leave a capital exporter worse off than if the investment had all been in the home country.

2 Notions of Neutrality

2. **Capital Import Neutrality (CIN)** – Neutrality in the source of investment from a govt's viewpoint.

- Domestic companies should be protected from a higher tax burden in a foreign market than TPs from other countries operating in the same market i.e. all firms of all nations pay the same tax rate.

Double Taxation

- Double taxation is defined as the imposition of (income) taxes in **two or more states** on a taxpayer in respect of **the same item of income or capital**
- A third jurisdictional base, exercised in the international arena is assertion of the right to tax because of the citizenship/nationality of the individual.
- Differences in taxing principles results in **Double taxation** or **Double non-taxation.**

Double Taxation

- **There are two types of double taxation;**

1. Economic double taxation

- refers to the taxation of two different entities often by the same country with respect to economically the same income.

2. Juridical double taxation

- Occurs where more than one country attempts to tax the same income due to ‘jurisdictional’ conflict in rules used to determine residence and/or source
- Home country will tax income using the *residence principle* and the foreign country taxes using the *source principle*.

Juridical Double Taxation causes

i. *Dual residency claims*:
ii. *Dual Source Claims*:
iii. *Residence and Source Claims*:

Double Tax Relief Methods

- In international tax law, source jurisdiction is given priority
- the domiciliary/resident country does not tax income which has already been taxed at the source.
- The domiciliary country exempts such income from tax in one of two ways:

1. **The Exemption Method**
2. **The Credit Method**

Double Tax Relief Methods

1. **Exemption Method (Article 23A OECD Model Convention)**

- Under this method the country of residence does not tax the foreign income of its tax residents
- The Foreign income is exempt.
- This method is generally not used by majority of states and relies heavily on the imposition of comparable tax rates.

Double Tax Relief Methods

2. Credit Method (Article 23B OECD Model Convention)

- This method is used by most states and involves giving a credit by the residence state for the tax paid by its resident in the source state.
- The country of residence taxes income earned overseas but gives credit against tax charged for any foreign tax suffered.

• Questions?