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INTERNATIONAL DOUBLE TAXATION

REPORT

of the ICC's Committee on Taxation* prepared by Mr. Frank Bower, British Member of the Committee, and approved by the Committee, on 27 February 1947

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I. DOUBLE TAXATION AND WORLD TRADE

It is inevitable that in the aftermath of the second world war the injuries done by the war itself to world trade should demand and receive the first attention. The fiscal consequences of the war are patent. The dislocation of economic activity has created shortages of food, of goods, of transport, and of exchange. These in turn have led to increased intervention of the State in the field of private enterprise, which intervention takes various forms ranging in degree from nationalization and State monopolies down to the controls which are inseparable from planned economies. Rising prices in almost every country have reduced the value of previous investments and have rendered new investments hazardous, if not impossible. Increased State expenditure in the face of lower production has led to increases of existing taxes and to the creation of new taxes. The financial difficulties give rise to defensive measures to protect the balance of payments with the result that physical controls of the production and movement of goods and financial controls of payments and investments are the general rule rather

* See page 2 for footnote

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These obstacles to the resumption of world trade are clear beyond the possibility of doubt, and that fact gives ground for hope that remedial action can speedily be taken and, in the course of time, be made effective. The removal of shortages of goods and services is one of the first objectives of reconstruction, and it is reasonable to hope that within a few years the volume of goods available for exchange will be restored to pre-war proportions by the individual efforts of nations to win back their accustomed standard of life.

The danger to world trade which arises from international double taxation is less obvious but it is the more insidious because it grows more intense by reason of the very endeavours to restore the national finances. At a time when heavier taxation is a discipline and a patriotic duty, the reason is not immediately apparent why a recipient of income should be more lightly taxed on the ground that his income arises abroad or because he resides abroad. Nevertheless, if that income is taxed at the rate of two-thirds in the country where it arises and in addition the remaining one-third is taxed at the rate of two-thirds in the country where the recipient resides, the arithmetical result is that he is left with one-ninth part only of that income and the consequence is that he will extricate himself from that position as soon as possible by removing his trade to another place or by selling the investment to a person who is not subject to double taxation.

International trade is the proper field for private enterprise because governments have a natural aversion against a foreign Government carrying on business within its jurisdiction. Private enterprise cannot extend or even survive unless it can earn a yield which is reasonable in relation to the capital employed and to the nature of the risk. Double taxation at high rates of tax can paralyze and ultimately extinguish international trade. It is essential in the interests of world trade that double taxation should be removed by whatever methods may be practicable.

II. DEVELOPMENTS

II. DEVELOPMENTS IN RELIEF OF DOUBLE TAXATION SINCE THE WAR

In the eight years since the Copenhague Congress of the International Chamber there has been material progress in the theoretical solution of the problems and some practical progress in achieving solutions by some countries. On the other hand new problems have arisen from the imposition of capital levies in certain European countries.

1. Theory

The Fiscal Committee of the League of Nations met in London in 1946 to examine the work of two Regional Conferences held in Mexico City in 1940 and 1943. It further perfected three model bilateral conventions:

1. for the prevention of the double taxation of income and property.
2. for the prevention of the double taxation of estates and successions.
3. for the establishment of reciprocal administrative assistance for the assessment and collection of taxes on income, property, estates, and successions.

It noted with approval the recommendation in paragraph 34 of the Report of the Preparatory Commission of the United Nations to establish a Fiscal Commission of the Social and Economic Council and reviewed the types of problems which can profitably be further considered. (League of Nations document C.37M.37 1946 11A. 25 April 1946).

The International Chamber of Commerce approves the revised drafts as being satisfactory models on which particular bilateral agreements can be based. Their provisions if adopted will remove double taxation between two taxing authorities so far as double taxation can be removed by bilateral treaties. The models can be further elaborated but any omissions or ambiguities which remain do not justify further labour to create ideal conventions. In the first place perfection is unattainable, and secondly, an ideal convention is not practical in the sense that any agreement represents a consensus between two persons who start off with different views, and no

/two countries

two countries can establish the point of consensus at exactly the same place as any other pair of countries. This has been amply demonstrated in experience. So far as the model conventions do not fit the views of two contracting parties or do not cover the situations under discussion, it is for the two contracting parties themselves to evolve the required solution.

The ICC strongly supports the initiation of discussions for the conclusion of conventions on the lines of the models, in the interests of comprehensiveness and uniformity.

2. Practice

The two great trading nations, the United States and the United Kingdom, have advanced considerably towards the removal of double taxation, and the activity of these two countries furnishes the greatest present hope for the wider spread of bilateral agreements.

(a) The United States

There is a material difference between the method followed by the United States and that followed by the United Kingdom which is worthy of note. By Section 131 of the Revenue Code the United States gave unilateral relief to its residents in respect of foreign taxes paid by them on their income which was taxable in the United States. It is true that this relief does not go far enough in two respects: it gives relief only in respect of the taxes paid abroad by the United States taxpayer and, except in the case of foreign subsidiary companies, pays no regard to the taxes paid on the income by a foreign corporate body out of which a dividend arises to a United States taxpayer. Moreover in the case of the United States corporations the foreign tax credit is available only to the United States corporation which receives the foreign income, and is therefore limited to the United States tax payable on that income by the corporation to the exclusion of any further United States taxes payable by the shareholder on dividends out of the corporation.

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Nevertheless the shortcoming of the foreign tax credit actually given by the law should not be allowed to obscure the essentially sound idea of providing relief for foreign taxes unilaterally by domestic law. By virtue of such an arrangement the business enterprise of that country would be free to develop abroad without regard to the success or failure of negotiations for bilateral tax conventions with other countries. Tax conventions negotiated by the United States relieve the United States Treasury from granting a foreign tax credit to its taxpayers insofar as the conventions remove the origin tax and the reciprocal concessions given by the United States are at the cost of the United States Treasury and in favour of the foreigner who wishes to do business in the United States.

The United States has completed agreements on income taxation and death duties with the United Kingdom which are operative from 1 January 1945. An agreement has been made but awaits ratification with South Africa. An agreement has been made with Belgium but is not yet published. Following the entry into force 1 January 1945, of the Agreement concluded between France and the United States before the war, an additional agreement has recently been made with France which, however, is more concerned with the prevention of tax evasion than the relief of double taxation.

(b) The United Kingdom

The most notable event in relation to double taxation in recent years has been the change of policy by the United Kingdom. Previously there existed a scheme of relief within the British Commonwealth which aimed at cancelling the lower of the origin tax or the residence tax by the United Kingdom giving relief up to half its rate of tax, and the Dominion or Colony giving the balance of the relief. The introduction of Excess Profits Taxes gave rise to another formula whereby the lower of the United Kingdom EPT and the Dominion EPT

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was cancelled by each country giving relief in the proportion that its tax bore to the sum of the two taxes. These partial reliefs were supplemented in some cases by limited agreements which cancelled the origin tax on profits from shipping and air transport and on agencies where the agent was not authorized to conclude contracts and did not carry stocks.

Now the United Kingdom is prepared to negotiate conventions with any country, whether a member of the British Commonwealth or not, broadly on the lines of the model bilateral conventions drafted by the Fiscal Committee of the League of Nations, but excluding assistance in collection of taxes. Agreements have been made and are in force with the United States, Canada, Southern Rhodesia, and South Africa. Agreement has been made but awaits ratification with Australia. Agreements are pending with East Africa, West Africa, Newfoundland, New Zealand and Northern Rhodesia, and eventually agreements will cover all the Colonies and Protectorates of the United Kingdom.

Three material observations arise from the experience of the United Kingdom:

(i) No two agreements are exactly alike. Representing as they do the result of free negotiation between sovereign taxing authorities there has necessarily been concessions to opposing views which cause deviations from the standard form. It is significant that this should arise between contracting parties who speak the same language and hold much the same concepts of income and of income taxation. It is to be expected that other divergencies will arise when discussions begin with foreign countries which have other systems of taxation.

(ii) The granting of a foreign tax credit to United Kingdom

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residents in respect of any foreign tax is dependent on the successful conclusion of a tax convention with that foreign country. Without a convention there is no foreign tax credit. Therefore British business and investment in foreign territories is dependent for its development on the negotiation of a convention.

(iii) The foreign tax credit where it is applicable extends to the foreign tax which has been charged on the income by the foreign tax authority whether in the form of a profits tax or a dividend tax or both. It is not limited to the tax actually paid by the United Kingdom resident. Thus in the case of a United Kingdom resident shareholder in a foreign corporate body the tax paid by the corporate body is taken into account as well as the tax levied on the shareholder. Such complete relief from double taxation is only possible in a tax system which has avoided or eliminated internal double taxation. To this extent international double taxation is concerned with the internal tax system of countries, becaus a tax system which taxes the same income more than once by its domestic taxes cannot give a satisfactory credit against its domestic tax for the foreign tax charged on the income. The United Kingdom foreign tax credit is much superior to the United States foreign tax credit.

3. New Capital Levies

Some European countries which have suffered severely by the war have introduced new forms of capital levies for the purpose of restoring their finances and of spreading the cost of the damage over the general body of taxpayers. These levies combine a high proportion of the increase in wealth during the war with lower tax on all wealth existing on a post-war date. They are stated to be single levies which will not be repeated, but there is

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the possibility that if they prove to be an effective fiscal instrument to meet a national emergency their use may be repeated on the occasion of a new emergency.

The levies create new problems of double taxation. The owner of immovable or movable property may be called upon to suffer the levy in the country where the property is situated and also in the country where he resides, in some cases in entire disregard of the other levy by reason of the difference in dates by reference to which the levy is made.

If wholesale expropriation of private and business property is to be avoided it is essential that discussions should be initiated before the levies are paid in order to relieve the owner from the obligation to pay in both countries. Since the levies are of a new type and since they differ in design in each country, research is required both to define the situation of various kinds of property and of burdens on the property and to determine the method in which relief should be given. As in the case of the more established forms of taxation, relief can be given either by exempting the property in the country where it is situated or in the country where the owner is resident or domiciled, or by taxing all or certain types of property less debts in the country where it is situated and also in the country where the owner is resident or domiciled but with a deduction from the latter levy for the levy paid in the former country.

Since the principal countries concerned with these levies are adjacent to each other it will be desirable to design a uniform method of relief by discussion between the government experts without delay. It is understood that discussions have been opened between France and Belgium to deal with the problem as it arises between the two countries. These discussions could usefully be extended by an invitation to the other adjacent countries who have similar capital levies to participate in a solution of the common problem.

/III. CONCLUSIONS TO

III. CONCLUSIONS TO BE DRAWN ON METHODS OF AVOIDING DOUBLE TAXATION

1. Exemption of Foreign Income or Property

There is only one perfect method of avoiding international double taxation of income and property. It is that each taxing authority should tax only the income and property which arises or is situated within its tax jurisdiction, and that each authority should have similar rules for allocating income and for determining the situation of property.

In States where there are more than one taxing authority the taxes paid to subordinate authorities should be treated as prepayments of the taxes due to the superior authorities. This would avoid internal double taxation by the central State and by the subordinate authority.

In order to preserve the principle of taxing according to ability to pay it would follow that the country of residence should tax the income or property within its borders by reference to higher rates of tax because of the existence of income or property outside the territory so as to levy equivalent rates of tax to those payable by a resident whose entire income or property arises or is situated in the country. In the country of origin or situation the income or property of non-residents should be taxed in general at a moderate flat rate without any enquiry into the total income or property of the non-resident.

It is not necessary that all States should conform to this ideal. Any one State can avoid double taxation for its residents by confining its taxation in this manner.

Such a system, however, must, in present circumstances, remain an ideal and not a reality because there are few countries which can refrain from taxing income which arises or property which is situated abroad.

2. Unilateral Foreign Tax Credit

The next best method of avoiding international double taxation is that the State which taxes income arising, or property situated outside its jurisdiction should provide by its law to give unilateral relief from its

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taxes by means of a foreign tax credit equal to the lower of the foreign tax or the home tax which is charged on the income. Such unilateral relief enables business activity to develop in foreign territories on equal terms with domestic business, without being dependent on the success or failure of bilateral conventions with other countries. Negotiations for bilateral treaties are then primarily the concern of the respective Governments so as to regularize and simplify the administration of taxes.

This method of unilateral relief is inferior to the first method of limitation of the residence tax in that relief can only be given against similar taxes. For example, if the foreign tax is a tax on capital and the home tax is a tax on income it is not possible to give relief from double taxation without arbitrarily converting the capital tax into an income tax by some co-efficient which could never be appropriate.

It is also inferior in cases where there is internal double taxation, e.g. taxation of corporate income in the hands of the corporate body and again in the hands of the shareholder as a separate taxable subject. The foreign tax credit in such cases will regard only the foreign tax paid by the shareholder to the exclusion of the tax paid by the corporate body, and will apply the relief only to the home tax payable by the first recipient inside the jurisdiction, e.g. the corporate body, and pay no regard to the taxes payable by the shareholder on dividends derived from that income.

3. Bilateral Conventions

The third method of avoiding international double taxation is by means of bilateral conventions, but the bilateral conventions can vary in quality by infinite gradations from comprehensive agreements to those which are so limited as to be almost valueless.

Even the better type of bilateral agreements are open to the two defects mentioned above in connection with unilateral foreign tax credits, and in addition to the following weaknesses:

(a) Bilateral agreements cannot touch the problem of income which arises in a third country. They can only deal with income arising

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in or property situated in the other contracting country which accrues to or belongs to a resident of the first country. For example, a bilateral convention between country A and country B for relief of taxation of income cannot cover income arising and taxed in country C to a permanent establishment in country B of a resident of country A. Nor would a bilateral convention between country A and Country C cover such income because the income would reach country A in the form of income from country B.

(b) Bilateral agreements operate only between the taxing authorities which make them. It frequently happens, especially with countries which have a federal constitution and the member States have independent taxing powers, that one or more of the member States refuse to be parties to the agreement.

(c) Bilateral agreements are easily avoided without breach of them by the creation of new taxes of a type which are not mentioned in the agreement. This is a temptation to a country which may take the narrow view that it is losing more revenue by reason of the agreement than the other contracting party.

4. Plurilateral Conventions

The weaknesses of bilateral conventions which are referred to in (a) and (b) above would tend to disappear as the number of conventions grows because income which is not relieved by one convention may be relieved by another. It was the realization of these weaknesses which gave rise to the preference on technical grounds for a convention to which many countries could be contracting parties. In practice, however, it has proved impossible for a large number of countries to join in signing a uniform convention. This does not, however, preclude the hope that progress toward uniformity may be made by starting the basis of existing bilateral conventions. The negotiation of conventions for the avoidance of double taxation is difficult in any case and there is no need to add to the

difficulties by requiring uniformity at the outset. It is found in practice that when once a convention has been made and has been found to be beneficial to the parties there is less reluctance to modify the terms of the existing convention than there was to make it in the first instance. It is in this respect that the model conventions designed by the Fiscal Committee of the League of Nations will have a strong influence in encouraging uniform development, apart from the obvious advantages in administration.

An encouraging sign of development of bilateral conventions into plurilateral conventions is the inclusion in the bilateral convention between the United States and the United Kingdom of an option to extend the convention to any colony or protectorate or mandated territory of either contracting party.

IV. THE UNITED NATIONS ORGANIZATION AND DOUBLE TAXATION

The Fiscal Committee of the League of Nations at its Xth and final session in March 1946 bequethed to its successor the further study of eight subjects set out in Annex B to document C.37 M.37 1946 11A, some of which go beyond international double taxation.

It is assumed that the Economic and Social Council of the United Nations will appoint a Fiscal Commission, and it is hoped that the Fiscal Commission will accept the studies suggested to it by the League of Nations.

It is satisfactory to observe that the draft charter of the International Trade Organization includes in Article 61 (5) the promotion of agreements for the avoidance of double taxation as one of the functions of the organization. This recognition of the need encourages the hope that in conjunction with the Fiscal Commission of the United Nations the ITO may be able to develop and to influence the adoption of an international code or the avoidance of double taxation among its members. The ICC will welcome an opportunity of assisting in the task of the Fiscal Commission and the ITO.
