CHAPTER 2
Jurisdiction to Tax

2.1 INTRODUCTION

Income may be taxable under the tax laws of a country because of a nexus between that country and the income or the activities that generated the income. According to international usage, a jurisdictional claim based on such a nexus is called "**source jurisdiction**". All countries that impose an income tax exercise source jurisdiction: that is, they tax income arising or having its source in their country.

A country may also impose tax on income because of a nexus between the country and the person earning the income. Such a jurisdictional claim over a person's income is called "**residence jurisdiction**". Persons subject to the residence jurisdiction of a country are generally taxable on their worldwide income, without reference to the source of the income – that is, the person is typically taxable on both domestic source income and foreign source income.

It is frequently said that most countries tax residents on their worldwide income and nonresidents on the domestic source income. Although this statement contains a grain of truth, it is a gross oversimplification of the scope of the tax systems of most countries. Countries that are said to tax their residents on their worldwide income never tax all of their residents on all of their worldwide income. Instead, these countries usually exempt their residents, especially resident corporations, on their income from active business carried on in foreign countries and income earned by foreign corporations in which their residents own shares. Similarly, countries that are said to tax on a territorial basis – that is, they tax only income derived from a source in their countries – often impose tax on certain items of foreign source income, such as fees paid by residents to nonresidents for technical services performed outside the country.

With few exceptions, countries that exercise residence jurisdiction do so only with respect to the income of individuals and legal entities that they consider to be residents: thus the term "residence jurisdiction". A few countries – the United States

(US) is the primary example – exercise jurisdiction to tax their citizens as well as their residents. They assert the right to impose income tax not only on the worldwide income of their residents, but also on the worldwide income of their citizens wherever they might be resident.

When a resident of a country earns income derived outside that country (foreign source income), the claim of that country to tax the income based on its residence jurisdiction may overlap with the claim of the country where the income is earned to tax based on its source jurisdiction. The claims of countries for tax revenue based on residence jurisdiction may also overlap with the claims of other countries based on citizenship or, in the case of so-called **"dual-resident taxpayers"**, on residence. In addition, countries with conflicting source-of-income rules may both claim to tax the same income. Unless resolved satisfactorily, the competing claims for tax revenue based on residence and source would discourage international commerce and investment. In addition, the tax burdens imposed on individuals earning income from cross-border transactions would be unfair under traditional concepts of tax equity. The measures that countries have adopted in their domestic legislation and tax treaties to mitigate international double taxation are addressed in Chapter 4.

Although persons engaging in transnational activities face risks of double taxation, they also have possibilities for international tax avoidance (sometimes referred to as double non-taxation). These opportunities result from certain gaps in the residence and source jurisdictions of most countries. The under-taxation of income from cross-border transactions is both inefficient and unfair. Under-taxation is inefficient because it distorts economic behavior; it induces taxpayers to engage in the under-taxed activities instead of taxable activities that may produce higher before-tax rates of return. It is unfair because individual taxpayers earning equal amounts of income do not pay the same amounts of tax.

Tax haven countries increase the risks of under-taxation of transnational income. Although tax havens may obtain some revenue from foreign taxpayers, the amount is small in comparison with the amount of tax revenue that other taxing jurisdictions lose on account of their conduct. The tax laws of many countries are replete with complex provisions designed to protect the legitimate tax claims of countries against the beggar-thy-neighbor policies and preferential regimes of tax haven countries. The most important anti-avoidance rules are addressed in Chapter 7.

Unilateral action by countries to block tax haven abuses has often been ineffective, due in significant part to the inability of the source and residence countries to obtain information about transactions routed through tax havens. Until recently, tax havens had strict bank secrecy rules and similar non-disclosure rules that facilitated tax avoidance and evasion by multinational enterprises and wealthy individuals resident in other countries. In the last decade or so, however, through a sustained project initiated and led by the OECD, bank secrecy has been eliminated and the exchange of information between countries to prevent tax avoidance and evasion has been improved significantly. The recent efforts to facilitate exchange of information for tax purposes are discussed in Chapter 8, section 8.8.4.

2.2 DEFINING RESIDENCE

For the purposes of taxing residents (and nonresidents), a country must provide rules that classify individuals and legal entities either as residents or nonresidents. The rules for determining the residence of individuals and legal entities are discussed below in sections 2.2.1 and 2.2.2, respectively. Certain tax treaty issues involving the determination of residence are addressed in section 2.2.3, below. The rules for determining residence (and, as a consequence, nonresidence) are clearly necessary for taxing residents on their domestic and foreign source income, but they are also necessary for taxing nonresidents on their domestic source income. The source of some types of domestic source income, such as dividends and interest, are usually based on the residence of the payer.

2.2.1 Residence of Individuals

An ideal test of residence is one that individuals and tax officials can apply to obtain a clear, certain, and fair result. Certainty is highly desirable because the tax consequences for residents and nonresidents are different, and individuals need to know whether they are resident or nonresident in order to comply with a country's tax law. Nevertheless, a simple and certain test for residence may be arbitrary and unfair, and may result in many individuals who engage in cross-border activities ending up as residents of more than one country. Therefore, the most that can be expected is a test that is simple, certain, and fair for the overwhelming majority of taxpayers but that is supplemented by more refined rules to deal with special circumstances.

In many countries, the residence of individuals is determined under a broad facts-and-circumstances test. The most significant manifestation of an individual's allegiance to a country is probably the maintenance in the country of a dwelling that is available for the use of the individual and his or her family. The following factors are also usually relevant:

- the location of the individual's income-producing activities;
- the location of the individual's family;
- the social ties of the individual to the country (e.g., bank accounts, club memberships, driver's license, etc.);
- the individual's visa and immigration status; and
- the individual's actual physical presence in the country.

Under this test, the tax authorities of a country decide, based on largely objective facts, whether an individual's economic and social connections with the country justify taxing the individual as a resident.

Unless buttressed by some simple presumptions, a facts-and-circumstances test is unsatisfactory because it is often excessively difficult to apply. A facts-and-circumstances test that uses certain objective tests to establish presumptions may provide a good balance between certainty and fairness. It may be appropriate for such a test to apply more rigorously in situations in which a taxpayer is attempting to give

up residence in a country than in situations in which a taxpayer is acquiring residence in the country. The following presumptions might be used, separately or in combination, to establish a prima facie case for residence:

- Individuals present in a country for 183 days or more in a taxable year are residents for that year, unless perhaps they establish that they do not have a dwelling in the country and are not citizens of the country.
- Individuals having a dwelling in the country are residents unless they also have a dwelling in another country.
- Citizens of a country are residents unless they have established a dwelling abroad and are regularly outside the country for more than 183 days per year.
- Individuals who are domiciled in a country may be considered to be residents of that country.
- Individuals who are temporarily absent from a country but intend to return and resume residence in the country may be presumed to remain residents of the country despite their temporary absence, subject to the rebuttal of that presumption.
- Individuals who have established residence in a country cannot relinquish residence status until they have clearly established residence status in another country.
- Individuals who have either resident or nonresident status for visa or immigration purposes might be presumed to have the same status for income tax purposes, although that presumption might be rebuttable.

Special rules may be necessary for certain individuals. For example, it may be appropriate to deem diplomats, military personnel, and other government employees to be residents of the country that employs them despite the fact that these individuals might not be residents on the basis of a facts-and-circumstances test because they spend most of their time outside the country.

Some countries use an arbitrary test, often tied to the number of days of presence in the country, for determining residence. Such a test may be used as a supplement to the facts-and-circumstances test discussed above. A common, but defective, rule or presumption is that an individual who is present in a country for at least 183 days during the year is a resident for that year. The 183-day test is probably enforceable in countries that exercise tight control over their borders; however, it is extremely difficult for the tax authorities of a country to enforce when many individuals are frequently entering and leaving the country without border checks, as occurs in the countries of the European Union. In most countries, the test probably cannot operate effectively unless the burden of proof is put on the individual to prove that he or she is not present for the 183-day period. Many individuals with substantial economic ties to a country can easily avoid becoming resident under the 183-day test by leaving the country before the 183-day threshold is passed. As a result, a country using that test is likely to catch mainly unsophisticated or ill-advised individuals, some of whom may not in fact have substantial ties to that country.

Domicile is a legal concept under the law of some countries by which an individual's permanent connection with a country is established. In general, domicile involves a more permanent connection with a country than residence. A person's domicile may be the country in which the person is born or in which the person's mother or father is domiciled.

2.2.2 Residence of Legal Entities

The residence of a corporation is generally determined either by reference to its place of incorporation or its place of management, or both. The **place-of-incorporation test** provides simplicity and certainty to the tax authorities and the corporation. It also allows a corporation to freely choose its initial place of residence. Countries that market themselves as tax havens typically offer convenient and inexpensive arrangements for incorporating under their laws.

In general, a corporation cannot freely change its place of incorporation without triggering a tax on gains that may have accrued in respect of its property, including intangible property that may have a high market value. Consequently, the place-of-incorporation test places some limits on the ability of corporations to shift their country of residence for tax avoidance purposes. Many countries use the place-of-incorporation test, although it is often combined with another test.

The **place-of-management test** is less certain in its application than a place-of-incorporation test, at least in theory. For many corporations engaged in international operations, management activities may be conducted in several countries during any particular taxable year. In practice, most countries using that test employ practical tests, such as the location of the company's head office or the place where the board of directors meets, to determine the place of management. The place-of-management test is used by the United Kingdom (UK) and many of its former colonies. Some countries, such as Australia, Canada, and the UK, use both the place-of-incorporation test and the place-of-management test.

A place-of-management test is easily exploited for tax avoidance reasons where a change in the place of management can be accomplished without triggering any tax. Assume, for example, that ACo is a corporation resident in Country A, which uses a place-of-management test. ACo has developed valuable intangible property that it intends to license to taxpayers located in Country B. To avoid tax in Country A on the expected royalties, ACo shifts its place of management to Country H, a low-tax country. The large accrued gain on ACo's intangible property is not taxable in Country A because no transfer of that property occurred. (However, as discussed in Chapter 3, section 3.4.1, several countries have adopted **exit or departure taxes** to prevent taxpayers from avoiding tax by changing their residence.) ACo then licenses the technology to users in Country B. The royalties received by ACo escape taxation in Country A because ACo is no longer resident in Country A.

If Country A in the above example used the place-of-incorporation test, ACo could not transfer its residence to Country H without undergoing a corporate reorganization that would probably result in the transfer of its assets to a corporation

organized in Country H. Such a transfer would trigger a realization of the accrued gain on the intangible property, thereby limiting or even eliminating ACo's opportunity for tax avoidance.

Countries that use a place-of-incorporation test exclusively (such as the US) have encountered avoidance schemes, called corporate inversions, whereby resident multinationals reorganize to avoid aspects of the residence country's tax system. Although inversions take many forms and are invariably quite complex, the following simplified example illustrates the general idea.

Assume that USCo, a widely held US-based multinational, wants to avoid the effects of the US CFC rules (discussed in Chapter 7, section 7.3). To do so, it establishes a subsidiary (Forco) in a country without CFC rules and then arranges for its shareholders to exchange their shares of USCo for shares of Forco and for the shares of all USCo's foreign subsidiaries to be transferred to Forco. The end result is that Forco is not a CFC in respect of any of its US shareholders and the CFC rules are no longer applicable to USCo because its foreign subsidiaries have become subsidiaries of Forco.

Many commentators argue that the proper purpose of the corporate tax is to impose tax burdens on a corporation's individual shareholders. According to this view, the corporate tax is paid in advance on behalf of the individual shareholders of the corporation to prevent them from deferring tax by investing in corporations. Therefore, the test of residence of a corporation might be determined, at least in theory, by reference to the residence of its shareholders. However, the application of a residence-of-the-shareholders test would present serious problems when residents of more than one country hold large blocks of stock in the company or when the stock of the company is publicly traded and the identity of the shareholders is difficult to determine. Taking this view to its logical conclusion, in effect, corporations would have to be taxed like partnerships, with each country taxing the share of the corporate income attributable to its resident shareholders.

For legal entities other than corporations, residence is generally determined either under a place-of-organization test or a place-of-management test. Determining the residence of a partnership is sometimes difficult because of the informality with which a partnership can be established: for example, in some countries a partnership may be created by virtue of the course of conduct of the relevant parties without the necessity for any formal legal documentation. In many countries, partnerships are treated as transparent or flow-through entities for tax purposes: in other words, the partners are taxed on their share of the income of a partnership, but the partnership itself is not taxed. For these countries, the residence of a partnership is usually irrelevant because the partnership is not a taxable entity.

Difficult problems also can arise under the laws of some countries in determining the residence of trusts. These problems are especially difficult when the country of organization, the country where the trustee or trustees are resident, the country where the grantor or settlor is located, and the countries where the beneficiaries are located are all different.

2.2.3 Treaty Issues Relating to Residence

Under Article 4(1) of the OECD Model Treaty, a "resident" of a country for purposes of the treaty is a person who is liable to tax in that country "by reason of his domicile, residence, place of management or any other criterion of a similar nature". Article 4(1) of the United Nations (UN) Model Treaty adds "place of incorporation" to the list of connecting factors. To avoid situations in which an individual is considered to be resident in both countries, Article 4(2) of both Models provides a series of **tie-breaker rules** to make the individual resident in only one country for purposes of the treaty. The first tie-breaker is the place where an individual has a permanent home; the second tie-breaker is the country in which the center of the individual's vital interests is located; the third is the place of the individual's habitual dwelling; and the fourth is the country of citizenship. If these tie-breaker rules are ineffective in making an individual a resident of only one country for treaty purposes, the "**competent authorities**" of the two Contracting States are mandated to determine residence by **mutual agreement**. Most modern tax treaties follow the tie-breaker rules in the OECD and UN Model Treaties closely.

For legal entities resident in both Contracting States, Article 4(3) of the OECD and UN Model Treaties make the entity a resident of the country where its place of effective management is located. According to the **Commentary** on Article 4, the place of effective management of an entity is the place where key management and commercial decisions are in substance made – the place where decision-making at the highest level on the most important issues of management takes place. Moreover, according to the Commentary, an entity can have only one place of effective management, although it can have multiple places of management. In my view, the Commentary dealing with the place of effective management is not convincing. Given the flexibility in the structure of the management of entities, it seems likely that key decisions can be made in multiple locations.

The place of effective management tie-breaker rule is not likely to be acceptable to countries that use a place-of-incorporation test as the sole test of residence for corporations. Many treaties attempt to resolve conflicts over the residence of entities by leaving the issue to the competent authorities to resolve. Some treaties use place of incorporation as the tie-breaker if the company involved is incorporated in one of the treaty countries. Other treaties provide that a dual-resident company is not considered to be a resident of either country for most treaty purposes; therefore, such a company is not entitled to any of the benefits of the treaty. This provision is intended to prevent the use of dual-resident companies for tax avoidance purposes; for example, a dual-resident company with losses would be entitled to relief for such losses in both countries in which it is resident.

The US insists on the inclusion in its tax treaties of what is commonly referred to as a "saving clause". The typical saving clause provides, with some exceptions, that the US reserves the right to tax its residents and its citizens as if the treaty had not come into effect. For example, a US citizen resident in a treaty country is not entitled to the reduced rate of withholding provided in the treaty on dividends received from the US. The OECD's BEPS Action 6: *Preventing the Granting of Treaty Benefits in Inappropriate*

Circumstances proposes to add a similar saving clause to the OECD Model Treaty (see Chapter 8, section 8.8.2.3).

2.3 SOURCE JURISDICTION

2.3.1 Introduction

By international custom, a country has the primary right to tax income that arises in, has its source in, or is derived from that country. As discussed in Chapter 3, under international custom the country of residence is generally expected to provide relief from double taxation if its residence jurisdiction overlaps the source jurisdiction of another country. In other words, the country in which a taxpayer is resident has only a secondary right to tax the taxpayer's income that is derived from or sourced in another country. Most tax treaties provide that the country in which income is sourced has the first right to tax that income and that the country of residence has an obligation to eliminate double taxation of that income. Although tax treaties give a country the first right to tax income sourced in the country, they usually provide that the source country must limit its rate of tax on certain categories of investment income and preclude the source country from taxing certain categories of income, even if the income arises in the source country.

Despite the priority given to source jurisdiction, the concept of source is rather poorly developed in domestic tax legislation and tax treaties. Unlike the term "residence", the term "source" is not used or defined in domestic law or in tax treaties. Thus, source rules are usually implicit in other rules. For example, withholding tax imposed on amounts paid by residents to nonresidents has an implicit source rule that such amounts are sourced in a country if they are paid by a resident of the country.

Most countries have only sketchy rules for determining the source of income, especially income derived from business activities. For example, in the UK and countries that were former UK colonies, income from business activities is considered to have its source where the real business is carried on. Such a rule is too vague to provide any guidance to taxpayers or tax officials.

The OECD and UN Model Treaties provide a mixture of implicit source rules and rules that function effectively like source rules. For example, under Article 11(4), interest income is taxable by the country in which the payer is resident and under Article 6, income derived from immovable property, including income arising from the operation of a mine or well, is taxable by the country where the immovable property is located. However, the OECD and UN Model Treaties do not contain any explicit source rules for business profits. Under Article 7, business profits derived by a resident of one **contracting state** are taxable by the other contracting state only if the resident carries on business through a **permanent establishment** (**"PE"**) located in that other state (Article 7) and the profits are attributable to the PE. This rule is the functional equivalent of a source rule.

In general, a PE is a fixed place of business, such as an office, branch, factory, or mine. The OECD and UN Model Treaties (Article 5) treat a dependent agent as

constituting a PE of its principal in some circumstances. Activities relating to the purchase of goods for export generally do not cause a taxpayer to have a PE. For additional discussion of PE rules, see Chapter 8, section 8.7.3.2.

Some provisions of the OECD and UN Model Treaties, such as Article 21 (Other Income), contain general wording that refers to income arising in a contracting state, without any further elaboration. In these circumstances, it seems inevitable that the source of income for that particular purpose must be determined under the domestic law of the country applying the treaty.

Good source rules should have the following characteristics:

- They should be broadly acceptable by many countries in order to ensure that double taxation is eliminated and double non-taxation is not facilitated.
- They should allocate income and tax on a reasonable basis that is broadly acceptable by most countries.
- They should be relatively clear and simple for taxpayers and tax officials to apply.
- They should be applicable on a reciprocal basis (i.e., a country should not unilaterally adopt a source rule that it would object to another country adopting).
- They should allocate income to a country where the income has a substantial economic connection (in the language of the OECD's BEPS project, income should be taxable in the country where value is added or created).
- They should not be subject to manipulation by taxpayers.
- They should not allocate income to countries that do not impose tax.

The source rules generally applicable to employment and personal services income, business income, and investment income are discussed below. The modifications of those source rules contained in the OECD and UN Model Treaties are also discussed.

2.3.2 Employment and Personal Services Income

The general rule in many countries is that income derived from personal services performed by employees, independent contractors, or professionals has its source in the country where the services are performed. Difficult allocation issues may arise when a taxpayer is paid for services performed in more than one country. Allocation among the countries where an individual performs services is typically based, at least in part, on the amount of time spent by the individual performing the services in each country. Some countries, including several South American and Latin American countries, consider income from services to be derived in their countries if the services are consumed or used (by customers or clients) in their countries even if the services are performed outside their countries.

Under Article 14 of the UN Model Treaty, income from services derived by professionals and other independent contractors is taxable by the country in which the

services are performed only if the service provider has a *fixed base* (which is equivalent to a PE) regularly available in the source country or spends at least 183 days in the source country. The OECD Model Treaty provided a similar exemption until the elimination of Article 14 in 2000. In tax treaties following the OECD Model Treaty, income from professional and other independent services is taxable as business profits under Article 7 and is exempt from tax by a country unless the service provider has a PE (rather than a fixed base) in that country. Under the UN Model Treaty, a taxpayer resident in one contracting state is deemed to have a PE in the other state if the taxpayer furnishes services in the other state through employees or other personnel with respect to the same or a connected project for a period of more than 183 days in any twelve-month period beginning or ending in the year. The Commentary on Article 5 of the OECD Model Treaty provides a similar deemed services PE rule as an alternative provision that countries may adopt.

One effect of eliminating Article 14 from the OECD Model Treaty has been to clarify that the various exceptions to PE status for preparatory and auxiliary activities in Article 5(4) and the agency PE rules in Articles 5(5) and (6) are equally applicable to income from professional and independent services. Both of these issues remain unresolved under the UN Model Treaty.

Article 15 of both the OECD Model Treaty and the UN Model Treaty provides that income from employment is taxable exclusively by the country in which an employee is resident unless the employment is exercised in the source country and the following conditions are met:

(1) the employee must be present in the source country for no more than 183 days;
(2) the employee is not paid by or on behalf of an employer resident in the source country; and
(3) the employee's remuneration is not deductible in computing the profits attributable to a PE in the source country of a nonresident employer.

In other words, an employee resident in one contracting state will be taxable by the other state on any income from employment duties performed in the other state for an employer resident in that state or for a nonresident employer with a PE in that state if the employee's remuneration is borne by the PE. Otherwise, income of an employee resident in one contracting state from employment exercised in the other contracting state is taxable by that other state only if the employee is present in the other state for 183 days or more in any twelve-month period beginning or ending in the relevant year. (See Chapter 8, section 8.7.3.3.)

2.3.3 Business Income

The taxation of business income by source countries varies considerably. However, two general patterns can be noted. The most common pattern, consistent with Article 7 of the OECD and UN Model Treaties, is that business income is generally taxable by

a country only if the taxpayer carries on business through a PE in the country and the income is attributable to that PE. In these systems, the PE rules serve not only as a threshold for taxation but also as the means for identifying the income subject to tax, namely, income "attributable" to the PE. Most European countries follow this general pattern; however, the definition of a PE under domestic law is often broader than the definition in tax treaties.

In many Latin American and South American countries, the PE concept is used to differentiate between the taxation of income from services derived by nonresidents on a net or a gross basis. Nonresidents who earn income from services through a PE situated in a country are taxable by that country on a net basis (i.e., the nonresidents are allowed to deduct expenses incurred in earning the income). Nonresidents who earn income from services performed in a country or consumed in the country but who do not have a PE in the country are taxable on a gross basis (without the allowance of any deductions) through a withholding tax.

According to Article 7 of the OECD and UN Model Treaties, the amount of income attributable to a PE is determined by assuming that the PE is a separate legal entity and that it deals at arm's length with other parts of the enterprise, including the head office, of which it is a part. Transactions between a PE and the head office are subject to the arm's-length transfer pricing rules. Transfer pricing rules are discussed in Chapter 6. In practice, most countries determine the income of a PE by relying heavily on the books of account of the PE, with adjustments made to those books only in cases of perceived abuse. The effect is to give substantial discretion to taxpayers to determine the business profits attributable to a PE. The rules for the attribution of profits to PEs are discussed in Chapter 8, section 8.8.5.

The other general pattern for taxing business profits is that the concept of a PE (or some functional equivalent) is used as a threshold requirement for the taxation of nonresidents but explicit source rules are used to determine the extent of the income subject to tax. The US is the most prominent example of this approach. Under US law, most categories of gross income are assigned a source. Deductions are then associated with items of gross income, generally in accordance with accounting conventions. Some items of business income are assigned exclusively either to the US or to foreign countries. For example, income derived from the purchase and sale of personal property is considered to have its source in the country of sale. Other categories of income are apportioned between foreign countries and the US, often by formula. For example, income from the manufacture and sale of personal property is apportioned between the country of manufacture and the country of sale, typically by a two-factor formula (sales and property). Telecommunications income generally is apportioned equally between the country of origin of the telecommunication signals and the country of reception.

A key feature of US source rules is the treatment of deductions. Many deductions are linked with gross income under accounting rules comparable to inventory accounting rules, under which deductions such as depreciation and other fixed costs are allocated for purposes of determining the cost of goods sold. However, special detailed rules apply to interest payments, research and development expenses, and certain other expenses that are difficult to link with specific items of gross income.

Most countries lack sophisticated source rules with respect to income and deductions. Accordingly, income and deductions are allocated between domestic and foreign income in accordance with general rules that give considerable discretion to taxpayers.

2.3.4 Investment Income

With some exceptions, most countries tax investment income derived by nonresidents, such as dividends, interest, and royalties, through withholding taxes imposed on the gross amount of the payment at a flat rate. Capital gains are not usually subject to withholding tax, although special enforcement measures are used by some countries, as discussed in Chapter 5, section 5.8.5. The source of investment income is usually determined by implicit source rules or their functional equivalents. With some technical exceptions, the following rules have been adopted by most countries and are endorsed in the OECD and UN Model Treaties.

- Interest, dividends, and royalties are considered to arise or be sourced in the country of residence of the payer. (See Articles 11(4) and 10(4) of the OECD and UN Model Treaties and Article 12(4) of the UN Model Treaty.) It is notable that the source rule for investment income relies on the residence of the payer of the interest, dividends, or royalties. Therefore, even countries that tax exclusively on the basis of the source of income (territorial taxation) require rules to determine the residence of persons. Special rules may apply to interest that is deductible in computing the profits attributable to a PE.
- Royalties paid with respect to intangible property are considered to arise in and are taxable by the country where the property is used and that provides legal protection for the intangible property. Some types of royalty income, such as royalties paid for the showing of motion pictures and royalties on computer software, may be classified as business income under the laws of some countries. No source rule for royalties is necessary in the OECD Model Treaty because exclusive jurisdiction to tax royalties is given to the residence country. However, under Article 12 of the UN Model Treaty the source country is entitled to tax royalties, with the setting of a maximum withholding rate left to negotiations between the treaty partners. Under Article 12(4), royalties are considered to arise in the country where the payer is resident or, in the case of royalties deducted in computing the income of a PE, in the country where the PE is located.
- Rental income derived from the operation of a business is typically taxable under the rules applicable to business income discussed above. Rental income from immovable property is taxable by the country in which the property is located; therefore, implicitly the source of the royalties is that country. Rental income from the use of movable property is generally taxable by the country where the property is used; therefore, implicitly the source of the income is the country in which the payer is resident. Rental income derived from movable

property is taxable as business profits under Article 7 of the OECD Model Treaty and as royalties under Article 12 of the UN Model Treaty.

- The source of gains from the disposal of property varies considerably and depends on the nature of the property. Gains from the disposal of immovable property are almost invariably taxable by the country in which the property is located. This is the rule in Article 13(1) of the OECD and UN Model Treaties. Gains from the disposal of assets used in carrying on a business in a country are often taxable by the country in which the business is carried on. Under Article 13(2) of the OECD and UN Model Treaties, gains from the disposal of property used in carrying on a business through a PE in a country are taxable by that country. The structure of the OECD and UN Model Treaties allows the same country to tax both income and capital gains from the disposal of immovable property and assets forming part of a PE. Thus, the characterization of a gain as income or capital gain is determined under domestic law and is not relevant for purposes of the treaty.

Gains from the disposal of shares of companies or interests in a partnership or trust are generally subject to tax exclusively by the country in which the taxpayer is resident. However, if a nonresident taxpayer owns a substantial interest in a resident entity, some countries impose tax on the gains. Article 13(4) of the UN Model Treaty allows a Contracting State to tax such gains, but the OECD Model Treaty does not. Similarly, some countries tax gains from the disposal of shares in a corporation or interests in a partnership or trust if the value of the shares or interests is derived principally from immovable property located in those countries and owned by the entity. Both the OECD and UN Model Treaties allow the Contracting States to tax such gains. In effect, this provision is an anti-avoidance rule designed to prevent taxpayers from avoiding a country's tax on gains in respect of immovable property located in the country by transferring the property to a corporation or other legal entity established in the country, and then disposing of the shares of the corporation or interests in the entity.

As noted above, most countries entering into tax treaties agree to some limitations on the withholding tax rates applicable to interest, dividends, and royalties under their domestic laws. The intent of these limitations is to ensure that the source country does not impose excessive taxes on investment income and tax revenue is shared between the source country and the residence country. For a discussion of withholding taxes, see Chapter 5, section 5.9.2 and Chapter 8, section 8.7.3.5.

Some tax treaties eliminate source country taxation entirely for some types of investment income by mandating a zero rate of withholding; almost all of these treaties are between developed countries. The zero rate is premised on two assumptions: that the flow of investment funds between the treaty countries in the zero-rate categories is approximately equal, and that the tax jurisdiction relinquished by the source country will be exercised by the residence country. As discussed in Chapter 8, section 8.2.1, these assumptions do not reflect reality in many circumstances.

Some commentators favor residence taxation of investment income over source taxation on the ground that a withholding tax at source may operate in some

circumstances as an excise tax on the payer, whereas a residence tax generally operates as an income tax on the recipient of the income. As an example of this excise-tax effect of withholding taxes, consider a foreign bank that requires a borrower to make interest payments net of any withholding tax imposed by the source country. In such circumstances, the borrower is likely to view the withholding tax as an additional cost of borrowing.

In theory, zero rates of withholding simplify administration and promote business efficiency by allowing intercompany transfers to be made without tax consequences. In practice, zero rates may promote tax avoidance schemes and, in the absence of complex anti-avoidance rules, may provide unintended benefits through treaty shopping. Treaty shopping occurs, for example, when treaty benefits are obtained by corporations that are nominally resident in a treaty country but are owned beneficially by nonresidents. For a discussion of treaty shopping, see Chapter 8, section 8.8.2.2.