CHAPTER 3

The Current International Tax Architecture: A Short Primer

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INTRODUCTION

When a business activity crosses national borders, the question arises as to where the profits resulting from that activity should be taxed. In principle, there are at least three possibilities for assigning a taxing right:

- *Source:* the countries where production takes place
- *Residence:* the countries where a company is deemed to reside
- *Destination:* the countries where sales take place

The generally applied tax architecture for determining where profits are taxed is now nearly 100 years old—designed for a world in which most trade was in physical goods, trade made a less significant contribution to world GDP, and global value chains were not particularly complex. This chapter describes briefly that traditional architecture and sets the stage for following chapters that provide more detailed explanations and set out various possible approaches to developing a framework better suited to modern economic circumstances—one which could potentially be perceived as fairer among countries that now play different roles in global value chains.

The current international tax framework is based on the so-called "1920's compromise" (Graetz 2001, p. 262).[1] In very basic outline, under the "compromise" the primary right to tax active business income is assigned where the activity takes place—in the "source" country—while the right to tax passive income, such as dividends, royalties and interest, is given up to the "residence" country—where the entity or person that receives and ultimately owns the profit resides. The system has, however, evolved in ways that considerably deviate from this historic "compromise," and international tax arrangements currently rest on a fragile and contentious balance of taxing rights between residence and source countries (IMF, 2014).

[1] The *Report on Double Taxation*, submitted to the Financial Committee of the League of Nations in 1923 (League of Nations 1923), defines not only the fundamental structure of the current international tax system but also its key concepts.

The determination of where income is to be taxed when activities cross borders therefore requires the following: determining the nature of the income (active versus passive); where the source of the income is; where the residences of the parties involved are; and, importantly, whether the activity has sufficient linkages to the source country ("nexus") to be deemed allocable there.[2] In the current architecture, assuming that the income in question is "active" *and* that there is sufficient nexus with the source country, the net profit is allocated by the parties by means of the "arm's length principle"—pricing all individual transactions between related entities as if they were taking place between unrelated entities in a competitive market—and thus determining the profits deemed to arise in each country involved in the chain of business transactions.

While domestic laws of each individual country set out the rules generally described in the preceding paragraph, the international taxation system is—very importantly—overlain with a network of more than 3,000 bilateral double-taxation treaties. These typically add (among other functions) a layer of definitions and income allocation rules that try to bring into alignment, and therefore can alter, the rules imposed by the individual signatories. Most of these treaties follow fairly closely one of two models— the OECD or the UN. Most significantly, tax treaties (1) define the necessary nexus for a source country to impose tax on active business income, and (2) give up (some or all) taxing rights in regard to "passive" income payments from within the source country to the "residence" country of the recipient. The key role of the international tax architecture is to govern the allocation of taxing rights between the potential tax-claiming jurisdictions to avoid both excessive taxation of a single activity and a nontaxation of a business activity.

In the course of a century-long evolution, the current international tax framework has turned into a hybrid construct, defined by a complex web of interactions between domestic laws and tax treaty obligations. The rules for assigning income to a particular geographical area reflect political, legal, economic, historic, and administrative realities. The resulting fairness—or unfairness—of the balance of taxing rights between jurisdictions with legitimate taxation claims is an increasing concern for the international tax community.

CORPORATE RESIDENCE

A corporation is a set of complex legal relationships; shoehorning it into the concept of "resident"—a word that would normally apply with respect to natural persons—presents definitional challenges (Couzin 2002). A corporation does not live and does not have a home. It can have a "residence," therefore, only if the law assigns it one (McIntyre 2003). Since there is no "real" home for a corporation, various residence criteria have developed over time, leading to significant divergences, overlap, and coverage gaps across countries.

[2] For a more detailed explanation of these issues, see, inter alia, Richard Vann (1998).

Defining the residence of a modern corporation is becoming increasingly difficult. In the early 20th century, when the concept of corporate residence was established as one of the international tax doctrines, the exercise appeared more straightforward. Considering any of the possibilities—jurisdiction of incorporation, the place of management and control, the country where most of the assets and jobs were located, or the country in which the company's main shareholders resided—would tend to point in the same direction with reasonable consistency (Graetz 2016). But such a classic multinational corporation, with an exact national identity and a fixed headquarters, is largely extinct. The manipulability of corporate residence allows multinationals to "mutate with remarkable ease" (Desai 2009, p. 1). The indicators that could establish a nexus with one particular state—where the company "was incorporated, where it was listed, the nationality of its investor base, the location of its headquarters functions"—now point in different directions, making it difficult to credibly assign where "home" lies (Desai 2009, p. 1).

A modern multinational corporation may have very good non-tax-related reasons to have more than one residence. In a context of a highly integrated global corporate operation, a multinational that aims at business optimization, value creation, and improved competitiveness in many cases will distribute its corporate and business functions among members of the corporate group that are primarily located in different places. As Michael Graetz notes: "It is no accident that we call corporations doing business around the world 'multinationals'" (2001, p. 320). These issues are further discussed in Chapter 7.

Residence criteria for corporations largely use two approaches in establishing a corporate residence.[3] One approach tests for a formal legal connection to the jurisdiction, such as place of incorporation or registration in the commercial register—a historical fact that cannot be changed, at least easily. The other establishes an economic or commercial connection of a business with the taxing jurisdiction, such as place of effective management, place of substantial ownership and control, or place where the board of directors meets (Ault and Arnold 2010). A combination of these two approaches is also used. Table 3.1 provides by way of example an overview of approaches used by several OECD countries in establishing corporate residence.

[3] Predictably, the discrepancies in corporate residence rules have become a fertile ground for tax avoidance and minimization schemes. An example was the "double Irish sandwich." Prior to 2015 companies were only deemed to be Irish tax resident if their place of effective management was in Ireland. A member of a "US multinational" could therefore be legally incorporated in Ireland but be a nonresident there for tax purposes if it was managed and controlled outside of Ireland. Since it was not incorporated in the United States, it would also not be legally resident in the United States. In 2015 Ireland changed the definition of tax residence to include not only entities that are effectively managed in Ireland but also those incorporated there (IMF 2018).

TABLE 3.1.

Tests to Establish Corporate Residence in Select OECD Countries

	Formal Legal Test	Economic or Commercial Connection
United States	Yes, a corporation is resident if organized under the law of the United States	No
Japan	Yes, a corporation is resident if its headquarters or principal office is organized in Japan	No
Sweden	Yes, a corporation is resident if registered under Swedish corporate law	No
United Kingdom	Yes, place of incorporation under UK law	Yes, place of central management and control, considered the place where the board of directors meets
Canada	Yes, place of incorporation under Canadian law	Yes, place of meetings of the board of directors
Australia	Yes, place of incorporation under Australian law	Yes, place of central management and control; additionally, the residence of shareholders, if a majority of voting power is held by shareholders
Germany	Yes, a corporation is resident if its statutory seat is in Germany	Yes, place of management, with focus on day-to-day management

Source: Ault and Arnold (2010).

DEFINING "SOURCE" OF INCOME

The principle of taxing net profit based at its source requires a method for dividing and allocating income and deductions to geographic locations. To do that, the current international tax system relies on the arm's length principle that requires that transfer prices—the prices charged in transactions of one party "related" to another—generally defined by reference to overlapping ownership—are the same as if the parties were not affiliated.

The application of the arm's length principle, in turn, assumes that the tax system is based on so-called separate accounting, where each part of an integrated multinational business is treated as a separate entity and is taxed on income determined from its separate accounts. Determining the source of income for related parties through implementation of the arm's length principle involves significant practical difficulties. Indeed, observing a fair arm's length price for related-party dealings, establishing a third-party transaction that is *comparable* to an intragroup operation of a multinational, is far from easy.[4] The system

[4] Moreover, under certain conditions the arm's length price might not exist, especially in a context of highly integrated global corporate operations. For example, suppose that two laboratories each invented and patented a single element of a highly valuable technological breakthrough. Viewed separately, at the arm's length, each patent would be priced at close to zero; the patents are valuable only when priced together. Here, the arm's length pricing of a single patent is pointless (Auerbach,

facilitates profit shifting through transfer price manipulation between related entities to minimize their global income tax liability by allocating income to jurisdictions in which income will be lightly taxed, if at all. This, in turn, leads to aggressive competition between governments to attract the mobile "shiftable" taxable income (Green 1993).

Pinpointing a jurisdiction where income is sourced has become increasingly difficult with globalization of cross-border production chains. Services could be considered sourced either where the service is performed, where the provider resides, or where the provider mastered the skills that allowed for the provision of the service. A royalty income could be sourced in the jurisdiction where the license of a patent is funded, where the patent is developed, or where it is registered.

Moreover, recent years have witnessed a technological revolution and expansion of digital products that have put further strain on the source-of-income concept (see Chapter 10).

Some question the normative foundations of source-based taxation, arguing that the source of income is not a sound economic concept. Income does not have a source; physical location is not a property that can be attributed to income (Ault and Bradford 1990). Income is a number, calculated by adding and subtracting other numbers; it cannot be interpreted as having a spatial property according to this view. Assigning geographical location to income is described as a "category mistake" by Mitchell Kane,[5] who notes that "the factual determination of income being located in a given jurisdiction . . . is conceptually incoherent" (2015, p. 328). Nonetheless, certainly an assertion by sovereign states of their right to tax activities within their jurisdictions is viewed by many as fair.

Pragmatic and administrative considerations gave rise to source-based taxation and may still be the most valid rationale. The country of source is in the best position to impose income tax (Graetz 2001). The jurisdiction that is best positioned to monitor an income-generating transaction should have the primary taxing rights over that item of income (Cui 2017). Indeed, the country of source is normally in a position to enforce a tax on cross-border income, as it can require both the reporting by local enterprises of the income and withholding taxes on payments thereof (Green 1993).

SO WHERE DOES THE TAX BASE FINALLY LIE?

In practice, essentially every country taxes active business income deemed sourced within it—provided that the activity giving rise to the income is sufficiently closely linked to the country under the standards of the current international

Devereux, and Simpson 2010). Equally meaningless would be an attempt to apply the arm's length principle as a pricing solution for transactions that create value from synergies, which a group of companies, if acting independently, could not create (Devereux and Vella 2014).

[5] Mitchell Kane, in turn, borrows the term from Gilbert Ryle (1949 [2002], pp. 8–12).

architecture. This typically requires a degree of physical presence (reflecting its origins in a world of commodities and physical goods, in a predigital age). This is the so-called permanent establishment or nexus concept. Legal incorporation in the country normally would constitute this, as would physical business locations in the country, and certain activities meeting minimum time or degree of activities such as construction work.

And source countries may also retain the right to tax profits remitted abroad in the form of passive income payments made by local corporations—to foreign lenders, owners, holders of intellectual property used by the company (in the form of royalties), or even payments to related providers of certain services—normally through withholding a certain percentage of such payments. Adjusting those withholding amounts downward from the level provided in domestic law—sometimes to zero, ceding the entire tax base of such payments to the receiving country—is one primary function of tax treaties.

Countries may, in addition to taxing passive income payments received by their corporate residents from foreign sources, assert taxing rights over active business income of their corporate residents where such income is sourced outside the country (earned abroad). This is referred to as a "worldwide tax system." Obviously, this approach would give rise to taxing that foreign-earned income twice—once in the source country, and again in the residence country. This is typically mitigated by a provision in domestic law granting a tax credit for the tax paid to the source country (a "foreign tax credit"). And tax treaties normally, too, impose the requirement to grant such credits.

The other approach for residence countries is to give up worldwide taxation—at least in regard to active income sourced abroad—and adopt a so-called territorial system, in which foreign-sourced active income of corporate residents is not taxed, through exclusion from the tax base. This approach, once uncommon, has now been adopted by essentially all advanced economies—most recently by the United States in its 2017 tax reform.

In practice, though, no country implements a pure territorial or worldwide model; there is a broad spectrum of variations between these extremes. Notably, for example, territorial systems may contain anti-avoidance mechanisms to prevent profits being shifted artificially abroad (for example, controlled foreign company rules) or may grant exemption only to selected countries through tax treaties. Box 3.1 explores the issue further and shows the evolution of taxation systems in the OECD over the last century.

TAXING CORPORATE INCOME BASED ON DESTINATION?

An alternative to assigning taxing rights based on source or residence is taxation at the destination. While this is not part of the current architecture for corporate income taxes, the destination-based principle has been long been accepted for VAT.

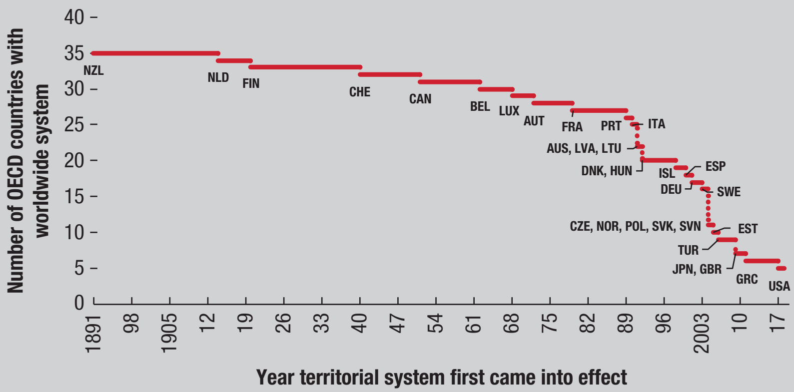
Chapter 13 explores the pros and cons of such destination-based allocation of taxing rights. Such an approach, while far removed from current norms, would be

Box 3.1. Territorial or Worldwide?

If the territorial and worldwide taxation systems are visualized as two opposite sides of a spectrum, the overwhelming majority of countries will fall somewhere in between. Nevertheless, for classification purposes, the countries with predominately territorial taxation elements—for example, some type of foreign dividend exemption system—are categorized as territorial, and countries with significant worldwide taxation elements are classified as having a worldwide tax system. With that in mind, as of June 2019, 31 out of 36 OECD member states have territorial tax systems (Figure 3.1.1). Interestingly, the pace of the shift from a worldwide to a territorial taxation model has been significantly accelerating over the last 30 years.

To the extent the foreign tax rate equals or exceeds the domestic tax rate, the foreign tax credit granted under the worldwide system for taxes paid abroad minimizes or eliminates the differences between a worldwide and a territorial system. Further, a system of deferrals—the postponement of current taxation on the net income or gain economically accrued by a taxpayer—such as existed in the United States before the introduction of the Tax Cuts and Jobs Act in 2017, can further blur the distinctions between worldwide and territorial systems.

Figure 3.1.1. Evolution of Taxation Model in OECD Countries: Shifting from Worldwide to Territorial System



Sources: PWC (2013) and the author.
Note: New Zealand and Finland effectively repealed (in 1988 and 1990, respectively) and reinstated (in 2009 and 2005 respectively) territorial systems. The year when the territorial system *first went into effect* is shown. Data labels use International Organization for Standardization (ISO) country codes.

more robust to profit shifting and tax competition. To apportion profit between jurisdictions, there would be "no need for massive economic studies that try to "estimate" arm's length prices in the absence of meaningful benchmarks" (Avi-Yonah, Clausing, and Durst 2009, p. 511). Further, the need for the whole host of anti-avoidance rules—including exit taxes, controlled foreign company rules, and anti-inversion rules—is also eliminated (Auerbach and others 2017). Thus, such a system is considerably more practical and robust from a tax administration point of view. On the other hand, the transition to such an approach would entail a massive reallocation of the tax base across countries, and in its pure form is not under serious consideration now. Nonetheless, destination-based elements are now being introduced in the current international discussions of overhauling the architecture.

CONCLUSION

The existing international tax framework is complicated, reflecting the diverging interests of the jurisdictions that designed it, as well as historical developments. There is a broad agreement on the framework of the system, but there are also plenty of exceptions, inconsistencies, loopholes, and ad hoc solutions. The compliance and administrative costs are enormous, and some definitions are not even conceptually clear—and are becoming harder to enforce and understand as the economy becomes less and less geographically attached. Changing the system to address specific difficulties occurs continuously. Introducing fundamental reform to shift to a coherent principles-based alternative is much harder and will entail intense political compromises.

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