Principles of International Tax

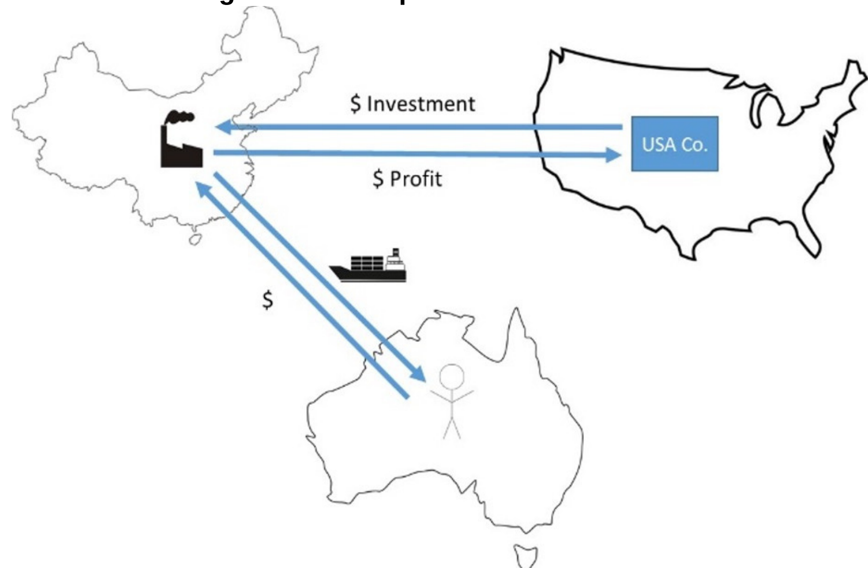
The international tax system is based on a series of principles that guide the allocation of taxing rights over income between countries [see our Tax Fact #15, "What is International Tax?"]. These principles, and the domestic laws and articles of bilateral agreements that they have informed, have helped nations avoid the negative impact on cross-border trade and investment that would result from more than one country seeking to tax the same income ("double taxation").

What are these principles? How have they been applied in domestic law and bilateral agreements? Why and how are they increasingly coming under pressure in today's modern economy?

What are the key international tax principles?

To illustrate the potential problem of double taxation, Tax Fact #15 included a simple example of a US widget manufacturer deciding to open a widget factory in Australia and sell widgets to Australians. The group of economists and officials that came together under the auspices of the League of Nations from the 1920s to devise a set of principles to guide collaboration, had a slightly more complex (and realistic) model in mind.

Figure 1. A sample cross-border investment



In this example, illustrated in Figure 1, USA Co, a widget manufacturer wants to sell its widgets in Australia. However, instead of setting up a widget factory in Australia, it manufactures its widgets in China to take advantage of the lower manufacturing costs. The widgets are then transported to Australia where they are sold to consumers.

Which country can tax the resulting profits?

There are three options:

(i) The country of *source*, being the country where the value-added activity takes place. In our example, the source country is China, where the widget is manufactured.

(ii) The country of *residence*, being the country where the entity, which financed the investment and ultimately receives income from widget sales in Australia, is resident. In our example, this is the USA.

(iii) The country of *destination*, being the country where the customer ultimately consumes the goods or services. In our example, this is Australia.

In the end, the early designers of the international tax system settled on the principles of source and residence (but not destination). It is important to note that these principles apply to the income generated by an activity. There may be related activities (such as consumption of the good) that give rise to other taxes, such as a goods and services tax (GST). In our example, GST may apply to consumption of the widget in Australia.

How do source and residence principles work in practice?

In practice, countries generally use one of two systems in applying these principles.

- Residence-based system: Under this system, residents of a country are taxed on their worldwide income (both local and foreign) whilst non-residents are taxed only on the local income (i.e. the income sourced in that country)[1].
- Territorial system: Under this system, only local income (income sourced in that jurisdiction) is taxed.

In operationalising these broad systems, there are a number of challenges. This includes how to determine whether someone, or some entity, is a resident of a particular jurisdiction and where income is sourced.

Tax residency is not the same as citizenship. It is a measure of an individual or an entity's economic connection with a particular jurisdiction. For most individuals and entities, their tax residence is readily apparent. For those that are internationally mobile, it can be more complex. Sometimes a taxpayer may find themselves a tax resident of more than one jurisdiction – in such cases, the "tie-breaker" rules contained in tax treaties can be used to sort out competing claims for resident tax treatment.

Similarly, the *source of income* is usually obvious. The interest you earn in an Australian bank account, the rent you earn from an Australian property or the salary you earn from an Australian employer, is sourced in Australia. However, complexity does arise, particularly in relation to multinational enterprises operating across borders.

Take the stylized example in Figure 1. Why is it that the profits from selling the widgets are sourced and therefore taxable in China rather than Australia? This is where the concept of *permanent establishment (PE)* arises. This concept implies that, if the sale of the widget in Australia is being undertaken through a fixed place of business (such as a physical shop) then some of the profits will indeed be sourced in Australia. If not, they are considered to be entirely sourced (and therefore taxable) in China. In effect, the concept of a PE acts as a threshold on the level of activity an entity can undertake in a jurisdiction before its activities are "sourced" there.

Principles under pressure

These principles, as well as the legal concepts through which they have been operationalised, served the international tax system well for many decades. However globalisation and the digitalization of businesses has increasingly placed these principles, and the global consensus framed around them, under strain.

Multinational enterprises (MNEs) have come to dominate global trade and investment. Often consisting of many entities, they have complex global supply chains with assets and labour located in many countries. Strategies used by MNEs to shift profits from high taxing jurisdictions to low taxing jurisdictions – that is, the manipulation of the amount of income sourced in a particular jurisdiction – has been a focus of the G20/OECD work on Base Erosion and Profit Shifting (BEPS).

Another focus of this work has been the tax treatment of digital companies such as Google, Apple, Facebook and Amazon ("GAFA"). Such companies have raised concerns because, although they often have very large economic footprints in countries, under the current rules this does not necessarily translate into a tax liability. Concepts such as a "permanent establishment" contemplated "brick and mortar" type investments, whereas digitalization increasingly means companies can have little or no physical presence in the countries in which they operate.

Although the BEPS process has focused around the idea that profits should be taxed where value is created, reaching a consensus around where value is created, particularly in the case of digital companies, remains a subject of ongoing negotiation. A number of countries have, for example, argue that value is derived from the consumer – or, to put another way, that the country of destination in Figure 1 should be allocated taxing rights.

These issues are considered in more detail in Hathorne and Breunig (2020)[2].

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[1] A few countries, most notably the US, tax on a citizenship rather than a residency basis. This means that, if you are a US citizen, then regardless of where you are living and your level of economic connection with the USA, you are expected to file an annual tax return in the US.

[2] Hathorne, C & Breunig, R (2020), Digital Services Taxation: An introduction and policy options for Australia, TTPI Policy Brief 7/2020, Canberra, 2020.

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