Rethinking tax jurisdictions and relief from international double taxation in relations with developing countries: Legal and economic perspectives from Europe and North America

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I. Introduction

Countries have historically claimed the right to tax all income generated within their boundaries. With respect to income generated by domestic factors (labor or capital) outside of its borders, countries have followed one of two approaches. One approach is to effectively cede jurisdiction to the foreign country by exempting such income from domestic taxation; this is termed territorial taxation. The second approach is to claim jurisdiction and subject such income to domestic tax but to give a credit for foreign taxes paid (up to what would have been paid had the income been generated domestically). The credit method maintains domestic tax jurisdiction but cedes the revenue generated by the foreign tax rate to the foreign country. Should the tax obligation owed to the foreign country be less than the obligation that would have been owed to the home country, the home country collects the difference under the tax credit method whereas no home tax is owed under the territorial method. The method of relief of international double taxation is thus central to the effective tax jurisdiction claimed by the home country. The specifics of double taxation relief also often depend on bi-lateral tax treaties and sometimes multi-lateral tax agreements or legal rulings (as in the case of the European Union for example).

The credit method allows for taxation in the country of source, while also allowing taxation of the overall income or capital in the taxpayer’s country of residence. The latter characteristic is argued to be important in ensuring capital-export neutrality and consistency in a nation’s application of the ability to pay principle. Capital-export neutrality implies efficiency in the worldwide allocation of capital, but other sorts of neutralities and efficiency criteria have come to the fore of recent discussions. With respect to ability to pay criteria, it is argued that without additional tax levied by the home country, factors with high ability to pay may escape correspondingly high tax by locating in low tax jurisdictions.

This rationale is not universally accepted, however. High-tax jurisdictions applying the exemption method implicitly accept any inconsistency in the ability to pay principle embodied in their system. The ability to pay view has also been questioned in the legal literature and additional criticism can be raised in the light of European law and the context of economic globalization.

Although taxation is important for location of foreign direct investment in developed countries, it is probably not the most important factor influencing FDI in developing countries. More fundamental aspects, such as low corruption and good infrastructure, are probably of more importance. Nevertheless, international tax policies of one country impact revenue and international tax policies of other countries, and this external impact is particularly acute (at least in a political sense) when one country is developed and the other is developing. Given that developed countries use various tools including direct aid to developing countries, the role of tax jurisdiction is worth re-thinking. In this paper, we review and re-examine the issue of international tax jurisdiction from economic and legal viewpoints with particular emphasis on the impact of developed country rules on developing countries. We also consider the impact of European law on the relations with non-EU Member States (hereinafter also: third countries).

The remainder of the paper is organized as follows. The next section sets the stage by examining economic views of tax jurisdiction and how it affects the developed-developing country relationship. This section also examines how recent US proposals to change the way the US taxes foreign income might impact developing countries. Surprisingly two recent proposals head in exactly opposite directions: the 2005 Bush Tax Reform Commission recommended moving towards a territorial system, while recent Obama Administration proposals look to tighten worldwide taxation. The following section

4 The European Association of Tax Law Professors analysed the European dimension of the ability-to-pay principle in its 2008 Congress, held in Cambridge. More details on this can be found in www.eatlp.org.

presents a legal view of tax jurisdiction with particular emphasis on the way in which European law and recent European Court cases impact developing country relationships with Europe. The final section argues that a move towards territorial taxation with respect to developing countries would be consistent with recent European court rulings, would give more autonomy in tax matters to developing countries, and could be seen as an alternative development tool. The biggest problems would involve cross-border flows of passive income and maintaining domestic ability to pay goals due to difficulty in taxing wealthy taxpayers, and we make some suggestions on ways to minimize this problem.

II - Economic views of international tax jurisdiction

II.1 Tax jurisdiction and efficiency

Economic views of tax jurisdiction tend to center around questions of world efficiency (how can tax jurisdictions be defined to maximize world income) versus national goals (how can countries define tax systems to maximize national income). Initial studies concluded that worldwide income could be maximized by taxing worldwide income and allowing a credit for foreign taxes, while national income could be maximized with a deduction system. These results follow from highly stylized models, however. For instance, the advantages of a worldwide system are most easily thought of in the context of a world of two countries where one is a capital exporter and the other a capital importer. In this context, the worldwide system with a (unlimited) foreign tax credit will lead to the efficient allocation of capital in the world. This is because no matter where a company invests, it will pay the tax rate of its home country on the margin. If the company invests at home, it will pay the home tax rate on its investment income. If it invests abroad it will first pay foreign taxes. But if the foreign tax rate is less than the tax rate at home the company will owe the difference to the home country; if the foreign tax rate is higher than the home tax rate, the company will get a refund of the difference (assuming an unlimited tax credit). Hence, no matter where the company invests, it will pay exactly the same tax on income generated and it will have no tax-induced incentive to invest in one country over another. This is called capital-export neutrality and results in an efficient allocation of capital across countries.

A second view is that the territorial system leads to an efficient allocation of savings across countries. A territorial tax system exempts foreign source income from tax and consequently all investors in a country face the same tax rate on the margin. For this reason it is said to comply with capital import neutrality. From an economic perspective, it is viewed as promoting savings efficiency because any international saving (interest from foreign bonds for instance) is not influenced by the tax system.

Both of these views have some validity. Worldwide residence taxation promotes investment efficiency but distorts saving decisions. A territorial system promotes the efficient allocation of savings, but distorts investment decisions.

A third view, developed primarily in the literature on sub-national taxation, is the benefit view. Under this view, taxes are payments for the provision of public goods and services. People and companies willingly pay taxes in exchange for goods and services provided by the government. Since people and businesses tend to consume public services where they are located, the tax jurisdiction should also be

defined with respect to where they are located. A territorial system approximates this situation, so under the benefit view, the territorial system would lead to efficient location decisions. Tax competition promotes efficiency in this view because it tends to force governments to provide goods and services such that the marginal benefit of the public good is just equal to the marginal cost of the tax payment.

A fourth view that has recently been raised is termed capital-ownership neutrality.\textsuperscript{8} Under this view, ownership of assets is important because owners that are better able to run certain types of companies can generate a higher return. Hence, it is important to distribute owners of capital to the type of capital in which they have a comparative advantage. According to this view, efficiency requires the tax system to be neutral with respect to ownership of capital. Capital-ownership neutrality can be achieved if all countries use the same tax system, whether it is a worldwide system or a territorial system.

To summarize, economic views of tax jurisdiction have concentrated on various types of worldwide efficiency criteria. These include capital-export neutrality, capital-import neutrality, capital-ownership neutrality, and the benefit view of taxation. Capital-export neutrality is associated with a worldwide tax system and implies efficiency in the allocation of capital across countries. Capital-import neutrality is associated with a territorial system and implies efficiency in international savings decisions. Capital-ownership neutrality can be achieved under either a worldwide or territorial system and implies efficiency in the matching of assets and owners. The benefit view requires those who benefit from public services to pay the associated costs, which is closely approximated by a territorial division of tax jurisdictions.

\section*{II.2 Tax jurisdiction and ability to pay principles}

One reason that countries may like to use a worldwide system and extend tax jurisdiction abroad is to preserve domestic progressivity of the tax system and ability to pay principles. Highly taxed factors that are not compensated with correspondingly high public services will have an incentive to escape the high taxes by locating in low-tax places. However, the degree to which this is possible likely differs between persons and companies. Many countries that have territorial taxation with respect to corporate income maintain worldwide taxation with respect to personal income. In addition, even in countries with corporate territorial systems, corporate passive income is usually subject to special rules that effectively tax such income at the home rate. Hence territorial tax systems tend to have many exceptions that attempt to preserve domestic ability to pay concerns.

\section*{II.3 Tax jurisdiction and foreign investment in developing countries

\subsection*{II.3.1 The importance of all public policies}

The empirical literature on taxes and FDI generally finds significant tax effects, though the estimated elasticity varies significantly between them depending on the data set used and whether the study is cross-sectional or panel.\textsuperscript{9} A set of papers from the 1980s use a time series of aggregate BEA data and


find significant effects of taxation on FDI with an elasticity of about -0.6. Others find significant effects when using the cross-sectional depth of the BEA data to examine FDI across countries for a given year. These studies also find significant effects, though with more variation in the point estimate of the effect of taxes. Other studies use firm-level data, usually in a panel, and again find significant tax effects.

The public finance literature thus generally finds significant effects of taxes on FDI. That said, studies also find that the impact is greater for developed countries than developing countries, and important factors for developing countries may include both the provision of adequate infrastructure and lower corruption. Chart 1 is illustrative and shows that average FDI stocks are higher when taxes are lower in both developing and developed countries, though the impact is somewhat greater in developed countries. This suggests that the benefit view of tax effects may be particularly important in the developing country case: developing countries need to pay close attention to providing the right kinds of public inputs and business environment (such as low corruption) that will foster foreign investment, and not be concerned solely with low taxes.

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13 For instance, Wheeler, D., Mody, A., “International Investment Location Decisions: The Case of U.S. Firms”, in 33 Journal of International Economics 1992, at 57-76 find a significant effect for agglomeration (as measured by infrastructure quality) and an insignificant effect for taxation. This study uses pooled data, however, which could bias the results if there are significant country fixed effects. In some preliminary work, Goodspeed, T., Martinez-Vazquez, J., Zhang, L., (2009) “Public Policies and FDI Location: Differences between Developing and Developed Countries”, find a negative impact of taxes, positive impact of infrastructure, and negative impact of corruption on inbound FDI. These effects differ between developing and developed economies, however, with the tax effects being significantly larger for developed countries and insignificant for developing countries.
II.3.2 The developing country problem in designing tax incentives

Developing countries can have difficulties designing tax policies to attract investment when major foreign investors use the worldwide system of taxation. Suppose, for instance, that a developing country attempts to use a tax holiday to attract investment. A tax holiday is a period of time (usually several years) during which a company enjoys a reduced (usually zero) rate of tax. In the simplest case, a foreign investor from a country that practices worldwide taxation will not benefit from the tax holiday. This is because any profits generated from the investment that are repatriated would be subject to the home country tax. The same would not be true of foreign investment coming from a country that uses a territorial tax system. Since the territorial country exempts foreign source income, any tax holiday or other tax incentive would not be offset by home country taxes.

And indeed tax holidays and tax exemption are common tax incentives used in developing countries. But these policies are ineffective when investment comes from countries with worldwide tax systems. Thus, the overall impact of a developing country’s tax incentives on inbound investment will depend on the extent of foreign investment from territorial or tax-sparing countries (versus worldwide countries) as well as the general impact of taxes on foreign investment.

Developed countries with worldwide tax systems have varying policies with respect to tax holidays of developing countries. Some countries, such as Japan, preserve the incentive created by the tax holiday by allowing a credit for taxes that would have been paid in the absence of the tax holiday. This policy is called tax sparing. Other countries, most notably the United States, do not. Foreign investment from
these latter countries thus cannot take advantage of any tax incentive offered by the developing country.

II.4 Tax jurisdiction as an optional tool to aid developing countries

Developed countries have explicit policies with the goal of increasing investment and incomes in developing countries. Direct aid is one often-used tool and indeed the United Nations has established a goal for overseas aid of developed countries at 0.7% of GDP. By some accounts, however, direct aid has not been particularly successful in increasing incomes of developing countries. In part this may be because important parts of market systems are missing or flawed in many developing countries. For instance, expropriation of assets and high corruption levels are not uncommon. The same might be said for taxation in developing countries. As argued above, a good business environment (low corruption) and use of public funds for public inputs desired by foreign investors are probably more important than tax jurisdiction per se. Nevertheless, the tax system may be one underutilized tool, especially for investment coming from certain developed countries such as the US that has a worldwide tax system but does not allow tax-sparing provisions in its tax treaties. Ironically, US domestic social policy has increasingly moved from direct programs to aid through the tax system. This is exemplified by the earned income tax credit, a refundable tax credit that has become the largest welfare program in the US. Of course, it is more complicated to use the tax system to try to encourage capital investment, and particularly to try to direct more investment towards low-income countries. Nevertheless, Table 1 shows that developing countries tend to use tax holidays and lower tax rates to try to attract investment. It may be possible to lead developed countries towards more efficient and effective means of attracting foreign investment through more coordinated policies between developed and developing countries.

<table>
<thead>
<tr>
<th>FDI Incentive</th>
<th>% OECD Countries</th>
<th>% Developing Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax exemption/holiday</td>
<td>20</td>
<td>55</td>
</tr>
<tr>
<td>Lower tax rate</td>
<td>5</td>
<td>45</td>
</tr>
</tbody>
</table>


Although the US has historically rejected tax sparing, the US is undergoing some rethinking of its international tax policies (as noted below) and this may be a time to rethink tax sparing as well. Tax sparing can be criticized on a number of fronts. These include the fact that tax sparing encourages

investment only for profitable companies and hence does not provide much incentive for new start-up companies that typically incur initial losses; possible transfer-pricing problems; and the possibility that tax sparing can change repatriation patterns, encouraging a more rapid repatriation of profits.

However, probably the most serious set of issues is the more general problem associated with tax havens that stems from the implied low tax rates of tax sparing agreements. A multinational can abuse a worldwide tax system (or indeed a dividend-exemption system) when one country has a zero or very low tax rate on capital while others have significantly higher rates. Among the games that can be played are loans from a low tax country that can be deducted in the high tax country and be counted as income in the low tax country; hybrid transactions particularly when debt in one country is viewed as equity in another; and pure abuse of transfer pricing rules. This is a serious and difficult problem and would probably be the single most important aspect in any tax sparing proposal. This is underlined by data in Table 2 below that shows that roughly 75% of US FDI stock in developing countries is in Latin American and Caribbean countries, and 40% of this is located in the British Virgin Islands.

Table 2: US FDI Stock Abroad by Country, 2003, ($billions).

<table>
<thead>
<tr>
<th>US FDI Stock Abroad by country, 2003 ($billions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Developed</td>
<td>1266</td>
</tr>
<tr>
<td>Western Europe</td>
<td>972</td>
</tr>
<tr>
<td>Other</td>
<td>294</td>
</tr>
<tr>
<td>Total Developing</td>
<td>83</td>
</tr>
<tr>
<td>Latin America and Carribean</td>
<td>70</td>
</tr>
<tr>
<td>South America</td>
<td>6</td>
</tr>
<tr>
<td>Venezuela</td>
<td>5</td>
</tr>
<tr>
<td>Other</td>
<td>64</td>
</tr>
<tr>
<td>British Virgin Islands</td>
<td>28</td>
</tr>
<tr>
<td>Neth Antilles</td>
<td>4</td>
</tr>
<tr>
<td>Panama</td>
<td>8</td>
</tr>
<tr>
<td>Mexico</td>
<td>7</td>
</tr>
<tr>
<td>Bermuda</td>
<td>6</td>
</tr>
<tr>
<td>Bahamas</td>
<td>1</td>
</tr>
<tr>
<td>Asia</td>
<td>12</td>
</tr>
<tr>
<td>Africa</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>1378</td>
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</tbody>
</table>


Recently there have been a flurry of proposals to reform the US international tax system, and any discussion should first underline the possible ways in which US international taxation may change. First, President Bush appointed a bi-partisan Tax Reform Panel that made recommendations on reforming US international taxation in 2005. Second, President Obama named a bi-partisan Tax Reform Commission that is due to release recommendations in December of 2009. Third, the US Treasury and President Obama issued a press release on May 4, 2009 that began to detail certain aspects of the President’s plan
to reform US international tax laws and enforcement. Perhaps surprisingly, the 2005 recommendations of the Tax Reform Panel and the May 4, 2009 proposals from the Treasury would move the US tax system in exactly opposite directions. In 2005, The President’s Tax Reform Panel recommended changing the US tax system to a territorial system. President Obama has suggested reforming the US tax system by limiting deferral and hence moving the US more towards a strict worldwide tax system. The differences are striking. By and large, the 2005 proposal would exempt foreign source income from US tax while the 2009 Treasury proposal would more heavily apply US tax to foreign source income. How would all this affect developing countries?

At first blush, one would think that a move toward to a territorial system by the US would make investment in low-tax developing countries more attractive for US multinationals. A territorial system would exempt dividend repatriations and thus would seem to encourage investment in these countries. Surprisingly, recent studies suggest that a move to a territorial system would not much impact US investment in low-tax countries. In part this is because multinationals are fairly adept at repatriating income without triggering additional US tax. However, this conclusion also depends on what developing countries and indeed multinationals do in reaction to such a change. If multinationals restructure agreements to lower royalty payments and increase dividend payments, or if developing countries change their tax rates (or bases), it could make investment in low-income countries more attractive.

In contrast to the 2005 report by the President’s Tax Reform Panel, President Obama and the US Treasury appear to be favoring a stricter version of worldwide taxation, arguing that such a change would increase investment in the US. The Treasury proposal suggests (i) reforming deferral rules to disallow deductions for expenses (except for research and experimentation) on foreign source income until taxes are paid on the profits; (ii) closing certain loopholes associated with the foreign tax credit; and (iii) eliminating “check the box” rules that enable multinational firms to choose their organizational form by checking a box, which can facilitate use of hybrid entities to avoid US tax. The details of these reform proposals are important (but not yet available). It is safe to say that they would constitute a stricter version of worldwide taxation, however. This would likely increase the difficulties of developing countries in attracting FDI.

If the US moves toward a stricter version of worldwide taxation, as appears likely, one option would be “partial” tax sparing agreements with developing countries. “Partial” tax sparing might go some way toward encouraging investment in developing countries but also minimize the problems that can arise with tax sparing agreements. The idea would be to discourage tax holidays per se but still try to allow a developing country’s tax system to encourage FDI by allowing credit of a certain percentage of US-owed tax. For instance, the US might allow tax sparing of, say, one-third of the US marginal tax rate. So if the US tax rate were 33%, repatriated profits that had been earned under a zero-tax holiday would be subject to a 21% tax when repatriated to the US. This could be made available to developing countries that negotiate a tax-treaty with the US along with an exchange of information agreement to limit abuse in tax haven countries. Such credits could be kept in a different basket or done on a per-country basis to avoid using those credits to shield income coming from high-tax countries. Furthermore, developing countries would have an incentive to implement a 21% tax in the example rather than a complete tax

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holiday because otherwise the US would receive the revenues. This might lead to higher revenues in the developing country which could be used for infrastructure investment needs; it could serve the dual purpose of encouraging investment in developing countries and limiting transfer-pricing or other problems with tax-havens (both because of the limit to the lower tax rate and the exchange of information agreement). One could also attach conditions related to good governance – limitations on corruption and expropriation of assets for instance – although good measures for such conditions might be difficult to obtain.

III – The legal rationale of international tax jurisdiction in the light of European law

III.1 The exercise of national taxing powers within the European legal system

The impact of European law on direct taxation was only analysed since the early 1990’s, i.e. after the European Court of Justice started to set a growing number of limits to the exercise of taxing powers retained by the EU Member States.

However, the attention for such issues has generally been focused on their dimension within the internal market, thus almost showing that European law was a matter for Europeans and within Europe. By contrast, an aura of uncertainty has for long surrounded the various scenarios involving third countries, almost ignoring that the evolution of European law, in particular since the liberalization of capital movements, gave European law an external dimension. Its repercussions in the field of direct taxation, mainly due to how the European Court of Justice interpreted fundamental freedoms in its case law, represent an important element for the purposes of our studies and in order to achieve a critical revision of the interjurisdictional allocation of taxing powers in relations with developing countries.

Preliminarily, one should consider that, for the purposes of our study (and at least from a tax and legal perspective) third countries are not a single homogeneous block, but rather represent a complex category made up of countries that share the element of not being Member States of the European Union, despite being in fact very different as to their respective features and needs, including the degree in which they share the goals of the internal market.

This characterization in function of European law is required because, from the perspective of EU Member States, such countries are obliged to exercise their tax sovereignty in a way to ensure the supremacy of European law and, from the perspective of non-EU Member States may have agreed, on the basis of an agreement under public international law, to limit their sovereignty in function of the goals of the internal market not only with EU Member States, but also with the European Union as such. Accordingly, previous research has grouped third countries in several categories, ranging from countries that are members of the European Economic Agreement and share almost entirely the goals of the internal market, to the countries that do so in a much more limited way.

16 A categorization in seven groups of countries has been put forward by Pistone, P., “The Impact of European law on third countries in the field of direct taxation”, in Intertax 2006/5, at 234????, including (i) EEA countries, (ii) EPA countries, (iii) Switzerland, (iv) developing countries, (v) the US, (vi) tax havens and (vii) all other countries.
For the purposes of our study it seems essential though to go beyond the traditional label of developing country and search for elements that define the complex features of such category in a more precise way. Such elements should, on the one hand, reflect the growing difference in economic growth and international tax policy needs arising inside this category and, on the other hand, comply with the legal requirements set by European law to the exercise of national tax sovereignty by its Member States. The first specification plays a particular important role for the purpose of justifying whether and to what extent developed countries should pursue goals of fostering economic development without paying particular attention to a reciprocal tax treatment, whereas the second one is required in order to admit a more favourable treatment nationals than the one that would apply to EU nationals within the internal market.

III.2 Developing countries: a complex category

Several States traditionally considered within the category of developing countries have recently been included in economic steering groups, such as for instance G20, showing that their role in the globalised economy is no longer marginal, but rather essential for achieving an effective international coordination.

Some of them still import capital from developed countries, while being net capital exporters to less developed countries (such as for instance in the case of Brazil, Russia, India and China, forming the so-called BRIC group, but also of several other countries like South Africa, or Chile, now being admitted to full OECD membership after adapting its international tax policy to the new role). This shows that also the traditional general differentiation between capital importing and exporting countries would be inappropriate for our purposes. For such reason, some developed countries have terminated previously concluded treaties including elements (such as notional credit) that were aimed at supporting economic development. Furthermore, from the perspective of European law, some of them enjoy preferential treatment on the basis of European international agreements, through which Europe increases their economic development on a non-reciprocal basis.

All these arguments suggest that, for the purposes of this study, instead of considering such countries as a single category, it is more appropriate to split them into two subcategories, respectively including the ones that could be defined as newly industrialized countries (NICs), which also include countries with a so-called economies in transition (such as for instance the former Member States of the Soviet Union), and the remaining ones that are truly capital importing countries (or CICs); each of the two categories will then require a different analysis according to whether or not they have concluded European international agreements.

NICs are extremely active in broadening up their tax treaty network to further increase their competitiveness on the worldwide scenario, which is already enhanced by low labour cost and moderate budgetary needs, thus making it possible for them to afford more moderate corporate tax rates than the ones applied by highly industrialized countries (that could be defined as HICs). The old treaties of NICs with HICs currently boost their economic development when including mechanisms like notional credits, giving a tax incentive for capital investment.

Such conditions generally do not raise significant problems of compatibility from the perspective of European tax law, though problems may arise in some specific situations. The most relevant example could be given by looking at the combined action of tax treaties with European international agreements

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17 As in the case of the German double tax convention with Brazil.
including a most-favoured-nation clause, which has so far received little attention by legal and tax scholars. Relations with third countries should instead enjoy protection against compensatory measures, extending the same line of arguments applied by the European Court of Justice to CFC legislation within the internal market in the Cadbury Schweppes decision.

CICs are instead mainly seeking to attract international capital to their territory in order to have sufficient resources available to foster their economic growth, thus having a very limited negotiating power with respect to MNEs. CICs include several territorial jurisdictions, have ultra-low labour cost and often insufficient financial resources for covering their budgetary needs. Fostering the economic development of CICs should still represent a priority for HICs, making it extremely important for such countries to master their own tax decisions, including the ones concerning the grant of tax incentives, without compensatory countermeasures by HICs. The same conclusion could be reached with respect to the policy that NICs should follow in their relations with CICs.

No problem of compatibility with European law should arise even when EU Member States give relief for taxes not effectively paid in the CICs, such as in the case of notional credits, provided that such measures apply in a non-discriminatory way. The main reason for such conclusion is that European law acknowledges the importance of promoting economic development. Furthermore, it can be argued that the conclusions reached by the European Court of Justice in the Cadbury Schweppes case should apply to any tax measure by EU Member States compensating lower taxation applicable on the basis of measures applicable in CICs.

III.3 The exercise of taxing powers by EU Member States in compliance with European law within the internal market and in relations with developing countries

The exercise of taxing powers is now considered with respect to three specific issues, namely (i) the scope of personal taxation, (ii) the exercise of taxing sovereignty on non-residents and (iii) the relief for foreign taxes. The goal of such analysis is to describe from a legal perspective how taxing powers should be exercised in such situation according to the common understanding in international taxation, as well as evaluate the impact of European law on such rules, including some consideration on the relations with third countries and in particular with developing countries.

III.3.1 The scope of personal taxation

Insofar as taxes are levied on a personal basis, a tax system will exercise its jurisdiction on any personal economic event related to the taxpayer. Accordingly, on the one hand, the taxpayer’s global income and capital will be linked up to the taxing jurisdiction of his country of residence (or, in some cases, nationality), whereas, on the other hand, such country will be obliged to allow for deductions that are related to the taxpayer’s personal situation. European law has pushed this obligation even further, disconnecting it from the revenue taxed by the country of residence and rejecting that the loss of tax revenue could constitute a valid justification for violating EU fundamental freedoms. No elements exist at present to exclude that the same conclusions may not be reached in respect of relations with third countries, including NICs and CICs.

Likewise, considering that losses will immediately affect the overall situation of the taxpayer, they should be taken into account by any system that exercise tax sovereignty on a personal basis. However,

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18 However, not all territorial jurisdictions are CICs. See for instance the case of Singapore, an international financial center with a good economic development, whose territorial tax system has a different justification.
many systems currently take into account foreign-source losses into account only to the extent that the tax jurisdiction is correspondingly exercised on foreign profits, based on a symmetry theory that tax treaties support, but which in fact prevents from taking losses into account whenever international double taxation is not relieved by the residence State through the credit method, but rather by means of exemption. This turns in fact the worldwide system in the latter situation into some kind of proxy for a territorial system, despite the structural differences that should instead exist on the basis of their different rationale. In the Marks & Spencer case European law has supported the obligation for the State of residence to import final losses even when incurred by foreign subsidiary in the presence of a group taxation regime. Although this case was decided on the basis of the right of establishment, similar conclusions could be reached in relations with third countries (including developing countries) on the basis of the free movement of capital. However, the current evolution of European law seems to show that the potential of application of the Marks & Spencer decision is very limited.

III.3.2 Objective taxation and comparison with residents of source State

The legal basis of territorial taxation is objective, or in rem, thus linking up income (or capital) as such to the taxing jurisdiction, because of its place of origin or source and regardless of any further circumstance that may be related to the person who produces (or owns) it. This legal difference has often been invoked to reject any possible comparison between taxation of residents and non-residents under international tax law, being the former ones liable to tax on a personal basis and the latter ones on an objective basis.

This view is also reflected in Article 24 of double tax treaties based on the Model Tax Convention on Income and Capital drafted by the Organization for Economic Co-operation and Development (hereinafter also: OECD MTC), affecting the very foundation of the non-discrimination principle contained therein. Such treaties therefore admit a comparison between residents and non-residents only to a very minor extent.

By contrast, a much broader comparison is possible in the light of European tax law since the Schumacker\(^\text{19}\) and Saint-Gobain\(^\text{20}\) decisions. Insofar as the situation of a non-resident EU-national is equivalent in an EU Member State other than that of his/its residence to resident taxpayers of such country (a matter which is usually determined by means of their relation to what part of their income/capital undergoes the taxing sovereignty of such country), then he/it shall also be entitled to national treatment in such country, regardless of whether he/it is entitled to the benefits of a double tax treaty under international tax law. This conclusion is necessitated by the primacy of European law over national law (including double tax treaties). By contrast, whenever no such similarity exists, the taxpayer enjoys no right to national treatment within the internal market, nor – under the current stage of evolution of European law - could he/it claim equal treatment among non-residents under a most-favoured-nation (MFN) approach\(^\text{21}\). However, the right to MFN exists in relations with some third countries, namely whenever European international partnership agreements, especially with developing countries, explicitly acknowledge it\(^\text{22}\). Since such treaties do not explicitly carve out taxation and no good

\(^{19}\) ECJ, decision 14.2.1995, case C-279/93, Schumacker.


\(^{21}\) ECJ, decision 5.7.2005, case C-376/03, D., paras. 61-62.

\(^{22}\) This seems fairly clear from the wording of the agreements with several ACP countries, economies in transition (such as mainly the former Member States of the Soviet Union) and countries of the Euro-Mediterranean agreements, which include a significant number of directly applicable most-favoured-nation clauses, especially on aspects involving the secondary right of establishment, but sometimes also involving the supply of services. See
arguments have so far been put forward for doing so implicitly at the level of interpretation, third country nationals may in fact enjoy a better situation than that of any EU national whenever none of such persons is entitled to invoke national treatment. Although one may question whether granting such better tax treatment to non-EU nationals is in fact consistent with the rules and goals of the internal market, a valid reason for doing so in relations with developing countries may be represented by the intention to foster their economic growth. Different reasons should instead be sought in relations with other countries, such as for instance increasing the economic relations or opening up their markets to the Europeans. However, a more circumscribed analysis of such goals falls out of the scope of our work and should also be sought on the basis of factual elements existing at time of concluding such agreements.

Since the current development of European law has taken it to exercise an immediate impact on cross-border direct taxation, also in relations with third countries, attention should be paid in the future when including MFN clauses into European international agreements, at least insofar as such agreement does not specifically carve taxation out of such type of clauses. Various reasons support this conclusion. First, MFN clauses often have undesirable tax implications as to the consistency with the international tax policy of a country and, in particular, with its treaties, which are often negotiated as package deals. Second, the implications of case law of the European Court of Justice in the absence of a coordinated European tax policy can be very far-reaching: removing obstacles to cross-border international situations may not necessarily comply with the need to consistently support a sound and well structured practice to foster economic development. Third, the Contracting States or such European international agreements must comply with the rules contained therein even when exercising their jurisdictions on the basis of the applicable tax treaties with EU Member States. Finally, a fourth argument arises from a completely different perspective, insofar as one considers that the very existence of such European international agreements may represent, in terms of European law, the legal basis for indicating that (at least a mixed) competence has been shifted to the Community level.

Additional issues arise in relations with non-EU Member States that have not concluded an EPA with the European Union. In such circumstances the impact of European law is mainly circumscribed to the scope of free movement of capital, whose worldwide scope puts an obligation on the EU Member State that is not connected to a condition of reciprocity. The A. decision of the European Court of Justice seems to support the view that the external dimension of such freedom expands whenever the right of establishment is not applicable. Furthermore, the need for ensuring an objective entitlement to such freedom should represent an important element to ensure its consistent application, thus opening it up

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23 Such situation would in our view affect the entitlement to lower withholding taxes and give rise to a number of inconsistencies. See further on this in Pistone, P., An EU Model Tax Convention, in EC Tax Review 2002/3, at 130-131 and, for some example of the possible inconsistencies arising in tax treaties, Vogel, K., Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law, in EC Tax Review, 1995/4, at 264.

24 Good examples of this kind are the agreements with Russia and Croatia. A paradox arises in the relations with Croatia, whereas exception being made for the free movement of services (currently not included in the European international agreement), the accession to the European Union will worsen its situation, downgrading it from MFN to national treatment for the right of establishment.

25 Nevertheless, relevant issues for the right of establishment could also arise in triangular cases involving non-EU Member States.

26 ECJ, decision 18.12.2007, case C-101/05, Skatteverket vs. A.
also to non-EU nationals who own such capital or derive income therefrom. Accordingly, one could conclude that the free movement of capital may be invoked in respect of measures put forward by EU Member States to dissuade the investment in developing countries. However, the European Court of Justice has not yet reached these conclusions, possibly for not being asked to judge on a case raising a similar issue. It has instead rejected the external scope of free movement of capital in cases that were also relevant for the free movement of services, whose external dimension lack an external dimension.

**III.3.3 Relief for double taxation**

When tax treaties do not allocate exclusive taxing powers to one Contracting State further problems may arise from the perspective of European law as to how relief for international double taxation is given. Relief methods may apply on a bilateral (i.e. through the provisions contained in the tax treaty itself) or unilateral basis (i.e. on the basis of domestic tax law), usually in the form of exemption (sometimes with progression), or credit for foreign taxes.

The application of either method has a different impact on the conditions for tax neutrality in respect of foreign-sourced income, as it will be more clearly analyzed from an economic perspective. However, also from a legal perspective a number of relevant issues arise in order to carry out a proper evaluation of the impact of European law on the relief of double taxation.

Using either method by the State of residence for giving relief of taxes levied in the Source State is mainly an issue that each State decides in conformity with its own tax policy. However, from the perspective of European law, the impact of such relief methods on cross-border situations within the internal market could create some compensatory effects of lower taxes that would not arise in respect of fully domestic situations, i.e. cases that fall under the tax sovereignty of one single Member State. Based on the arguments used by the European Court of Justice to regard CFC legislation as a restrictive measure for its compensatory effects on lower taxes levied by the foreign tax jurisdiction, one may therefore support the view that giving relief through credit would affect locational neutrality insofar as the residence State offsets the more advantageous tax treatment that could be available in the source country, thus making it impossible for the investor to compete at equal footing in the latter EU Member State.

Arguments to support this view could be drawn by looking at how the UK High Court of Justice implemented the *FII* decision of the European Court of Justice on the use of different methods for relieving economic double taxation in domestic and cross-border situations. Insofar as exemption and credit always have a different impact on income received by the shareholder, Member States may be free to choose either of them (and this reading would in fact be confirmed also by the Parent-Subsidiary Directive), but are obliged to apply the same method for both domestic and cross-border situations. One may therefore wonder whether national tax sovereignty could create such difference in treatment by using a relief method, such as credit that, when applied with respect to juridical double taxation,

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27 ECJ, decision 12.9.2006, case C-196/04, Cadbury Schweppes, paras. 45-46. Such decision applied to the right of establishment the same reasoning that the European Court of Justice had previously applied in tax and non-tax cases, such as for instance, with respect to the free movement of services in the decision 26.10.1999, case C-297/97, Eurowings, paras. 44-46.

28 UK High Court, decision 27.11.2008, case [2008] EWHC 2893 (Ch).

structurally has the effect of compensating foreign taxes levied on the same income. Within the internal market the issue is not just whether a taxpayer having cross-border income can bear the same tax burden that applies in the State of residence to any other taxpayer deriving the same amount of income from sources located within such country. It is likewise important to allow any taxpayer to compete at equal footing with residents of other EU Member States without tax measures of their State of residence that may dissuade him from investing his capital in countries other than that of his residence. The restrictive implications of foreign tax credit are particularly evident in the presence of per-country limitations and tax rate differentials, which prevent an effective consideration of the taxpayer’s overall ability to pay at the level of the internal market. Despite acknowledging that in some cases disparities among the tax systems can play a significant role, the need to remove tax obstacles within the internal market may lead the European Court of Justice to gradually remove the dissuasive effect created by foreign tax credit.

Such issue, however, is not an exclusive matter for the internal market, but also affects third countries, in particular due to the broader geographical scope of the free movement of capital in the EC Treaty. When considered in relation to developing countries, such compensatory effect may turn a preferential tax treatment given by the source State for the purpose of fostering investment on its territory into an additional revenue for the residence State of the taxpayer. Beyond any issue concerning whether such tax incentives should be given by the State of origin, from a legal perspective one could therefore conclude that the use of credit to relieve juridical double taxation is as such structurally inadequate to pursue a tax policy that supports economic development and does not interfere with the own decision of the source State. Such issues do not (or do to a lesser extent) arise whenever a notional credit is given by either tax sparing at nominal rates of the source State regardless of the tax actually born by the taxpayer or matching credit at fixed rates. Accordingly, from the perspective of European law none of such types of credits would have compensatory features and raise some problem of compatibility with fundamental freedoms in relations with third countries. Exemption would also make the tax policy decisions of the developing country become final, since it does not imply an actual exercise of the taxing jurisdiction over economic events taking place outside the territory of the residence State. However, for this very reason exemption does not allow for deduction of foreign losses, which would instead be creditable against domestic profits of the residence State under tax sparing or matching credit. Possibly, this reason would make notional credit more desirable than exemption with a view to supporting economic growth. The issue is here not much whether economic growth should be enhanced by giving tax incentives or subsidies, but rather whether tax treaties should still include clauses that make developed countries deprive developing countries of their own tax policy decisions, or by contrast let the latter countries have their fair share of revenue from income sourced within their territory.

Until now the rationale of worldwide taxation with relief by the credit method has been to support capital export neutrality, as opposed to capital import neutrality being pursued through the exemption method. However, the issue here could be whether developed countries may consider to give up their worldwide taxation in their tax treaties with developing countries in order to foster economic growth.

This matter is particularly sensitive in Latin American countries that support territorial-based taxation (but is also perceived in India, especially with respect to taxation of royalties and the justification of

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30 Surprisingly, the European Court of Justice took a different view in ECJ, decision 6.12.2007, case C-298/05, *Columbus Container Service*, para. 40 with respect to the application of German unilateral switchover clauses in a case concerning a Belgian coordination centre and its German partners. This decision creates tax fragmentation within the internal market and was not motivated on the grounds to achieve a proportionate reaction to abusive practices.
taxing powers based on the definition of their source), which often feel being expropriated of their own wealth by tax systems of developed countries that in fact link up to their taxing jurisdiction economic events that take place outside their territory. Shifting back to a purely territorial taxation could be a fairly complex issue to accept and implement for developing countries, at least in the present scenario of international taxation. Changing the existing tax rules in relations with one or more developing countries, perhaps on the basis of international treaties, could perhaps be a more realistic alternative.

Exemption is perhaps the less sophisticated way to implement such innovation without implying a major revolution\(^\text{31}\). Many feared that such method may automatically open up the way to low or no taxation on cross-border business, especially considering the strong negotiating power of some MNEs with governments of some developing countries wishing to attract international capital to their territory. However, the significant reduction of corporation tax rates over the past decade, in particular in Europe, may lead to reconsider the impact of such issue on cross-border business.

Two further arguments could be mentioned to support a shift towards exemption. First, insofar as the developing country reduces the level of its corporation taxes for all taxpayers (thus without giving rise to ring-fenced regimes for international capital), it would be perfectly in line with European law if tax treaties did not include measures to compensate for such lower levels of taxation\(^\text{32}\). Second, from a legal point of view, a revised strategy to support economic growth could simply cut off the legal connection between the taxing jurisdiction of the developed country and income that is sourced in the developing country and, by means of the applicable tax treaty is exclusively subject to the latter’s jurisdiction. In such situation major problems should not arise for the developed country to obtain all information that is required for the purpose of effectively carrying out its own jurisdiction. This conclusion seems supported by the dramatic change in international tax cooperation that is currently opening up an unprecedented worldwide expansion of mutual assistance in gathering information and collecting taxes.

Various alternative paths for exemption have been suggested in the tax literature, though two are particularly interesting for our purposes and will therefore specifically addressed hereby.

According to one proposal\(^\text{33}\), instead of sharing taxing powers on income from capital that MNEs export into developing countries, such countries could slice the tax base of such income, possibly in agreement with HICs, in order to enjoy exclusive taxing powers on its parts. In particular, such a proposal suggests that mobile rents - i.e. those derived from mobile factors of production that can be exploited in many different locations because the market for consumption is worldwide - should be taxed only in the country of residence of the MNE, whereas locational rents – i.e. net income arising from the factors of production belonging to a host country and consisting in the remuneration of capital exceeding the normal rate of return - should instead remain within the exclusive jurisdiction of the developing country.


\(^{32}\) Although European law does not interfere in principle with the allocation of taxing powers, the outcome of such allocation should nevertheless be compatible with the primacy of European law (see ECJ, Saint Gobain, para. 56-58), thus possibly excluding measures that compensate for lower taxes levied in another country (of course leaving aside the case of abusive practices), which in our opinion should also include third countries.

\(^{33}\) Barker, W.B., cit., at 374-377.
considering the important role that such country plays in the production of such income. The author also suggests the latter rent to be object of tax sparing provision in HICs. Attributing an exclusive jurisdiction to tax on cross-border income represents in principle a positive development in taxation of cross-border income, thus removing some of the problems related to the existing relief methods and achieving the importance result of preventing double taxation, rather than removing in full or part its effects.

Another proposal also supports the need to eliminate forms of shared taxation on cross-border income, though by assigning exclusive taxing rights to source countries on cross-border active business income and to residence countries of MNEs on portfolio income.

Both theories undoubtedly play a significant role in the research activity related to our study, in particular with respect to the output that is being drafted for the application in relations with Latin American countries. Preventing double taxation represents an especially important element to simplify the rules of taxation on cross-border income and remove the potential exposure to (also temporarily) unrelieved double taxation, while keeping a reasonable degree of fairness that can be positively (and with limited costs) handled by unsophisticated tax authorities. This reduces the likely exposure to (also temporarily) unrelieved double taxation, which represents a potential obstacle in the light of European law with respect to capital movements also in relations with third countries. All such reasons lead to question whether the former theory is in fact a good alternative to the latter one, especially if considering that (especially when applied unilaterally by the developing country, but in fact also in the presence of agreements with HICs) significant difficulties may arise in slicing the tax base in a way that exactly prevents double taxation from arising. Furthermore, both theories perhaps underestimate the reluctance of several developing countries (in particular CICs, but also of BRIC countries like in particular India in the case of royalties) to give up their sovereignty on what they consider as income fully produced on their territory. For such reason, some form of compromise between simplicity and fairness might be considered in order to achieve a solution that is also reasonably feasible to implement. Formulae could in principle be a good solution, though their determination by common agreement could give rise to the same problems that the separation of locational from mobile rents is likely to determine. Furthermore, their compatibility with European law could sometimes be hard to defend on a legal basis, taking into account that the European Court of Justice has so far shown a preference for ascertaining the existence of obstacles on the basis of effective situations.

A constructive solution could be provided by making use of some form of revenue sharing, which allows for the payment of a fee in respect of information gathered by the State of source and makes it possible for the latter country to maintain some revenue from cross-border income yielded by capital imported into its territory. Although economists have questioned its efficiency, from a legal perspective its application in the European common system for taxation of cross-border savings payments to EU beneficial owners made by paying agents located in Austria, Belgium, Luxembourg, as well as in Switzerland and a few other countries, seems fairly successful.

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Another possibility is the use of notional tax credits or “tax sparing” 37, which maintains the levels of taxation of developed countries without depriving the developing country of the positive effects of its own tax policy decisions. The main obstacle to shifting towards such method in relation with developing countries lies, however, in the traditional opposition developed in the 1960’s by the US and its scholars 38, which consider that relieving taxes regardless of their actual payment to the Revenue of the developing country can have several undesirable effects.

The European scenario, however, provides for a significant number of treaties including forms of notional relief for foreign taxes, though some countries have recently departed from such a pattern. Two examples could provide evidence of this trend. First, Sweden terminated its treaty with Peru, considering that notional tax credit was in fact leading to some undesired forms of tax arbitrage and abuse. Second, Germany terminated its treaty with Brazil, no longer regarding such country as a developing country and thus concluding that the rationale for such favourable treatment has disappeared. Little attention has been paid to the possible implications of European law in particular in the relations with Brazil, whose treaties with several other European countries include similar forms of relief by notional tax credit to the one contained in the treaty terminated by Germany. In such scenario, the right for a German company to enjoy national treatment in any of such European countries (for instance when having a PE on their territory 39) would automatically entitle it to national treatment and thus to an equivalent relief by means of notional tax credit to that which would apply under the treaty of such country with Brazil. In other words, the implications of European tax law on international tax policy of EU Member States show the need for an increased international tax coordination filling up the wall of silence that has so far surrounded this domain also among tax scholars on these issues.

However, one may argue that the issue is not so much tax sparing as such, but how such a policy is actually drafted, structured and implemented.

IV – Rethinking tax jurisdictions: a possible new model

This final section contains the combined output of research aimed at developing a new approach to the problems of international taxation in relations with developing countries. Such an approach is drafted in a way to combine legal standards currently set by European tax law (in terms of an effective removal of obstacles on international movements of capital) with a sound international business tax policy from an economic perspective and make it possible to foster economic development through taxation. Far from supporting with new arguments the use of tax incentives for such purpose, the goal of our work is to


39 A clear-cut case of such implications can be found in the decision of 9.5.2007 by the Finnish Supreme Administrative Court (KHO:2007:30), which, on the basis of the Saint-Gobain decision of the European Court of Justice, applied to cross-border royalties derived in China by a Luxembourg company with a permanent establishment in Finland an equivalent treatment to that provided by the China-Finland DTC.
stimulate debate in tax legal and economic literature on a possible reconsideration of the boundaries of
tax jurisdictions and methods for relieving double taxation in relations with developing countries.

More specifically, this section will focus its attention on the particular situation of Latin America,
considering that most Latin American countries share the same legal and tax tradition\textsuperscript{40}, despite the fact
that economic development (in particular of NICs) has led some of them to abandon the traditional
territorial boundaries of their national jurisdiction. The application to Latin America considers on the
one hand the relations among NICs and CICs of that region and, on the other hand, the relations of all
such countries with HICs, with special emphasis on EU Member States, which are bound by European
law to ensure free movement of capital also in relations with third countries even on a unilateral basis\textsuperscript{41}.

Preliminarily, we should recall the importance of European law in transforming the international tax
scenario from a mere matter of allocation of taxing powers among the States - without any international
rights for taxpayers - into an area in which the exercise of national sovereignty in the field of direct
taxation is subject to conditions in order to avoid tax treatments that in fact discriminate against cross-
border situations or otherwise dissuade taxpayers from investing their capital abroad. The broad scope
of prohibition of discrimination and restriction in the direct tax case law of the European Court of Justice
and the immediate rights for EU nationals to activate legal remedies against violations by the Member
States represent a Copernican revolution in international taxation, which is now gradually expanding
also to relations with non-EU Member States. From such a perspective, upgrading the legal standards of
international taxation in the external relations of the European Union and its Member States will soon
become a necessity from the legal perspective. Applying this pattern also to relations among non-EU
Member States would represent a significant step for international taxation from a legal perspective,
because it brings about an effective dimension of rights in cross-border situation, but also from an
economic point of view, because it fosters a spontaneous trend of economic integration, which
Corresponds to the needs of the globalised economy.

Such a scenario should be ideal for making taxation play a new role also in fostering economic
development: instead of giving financial subsidies or tax incentives, developed countries could
reconsider allocation rules in relation with developing countries. In particular, a general shift towards
territorial or exclusive allocation of taxing powers in cross-border situations could be pursued in
relations with developing countries. Exposure to international double taxation represents a considerable
burden for MNEs, often leading them to set up complex schemes to operate in specific countries.
Removing the risk of unrelieved double taxation for international business, or the possibility that HICs
compensate lower taxation in the State of source can possibly stimulate the investment of international
capital into developing countries and more significantly contribute to their economic growth. An
additional issue could arise from the perspective of preventing abusive practices that are currently

\textsuperscript{40} From a legal perspective, their tax systems are reasonably homogeneous, due to the structural influence
exercised on their current wording by the Latin American Model Tax Code (\textit{Modelo de Código Tributario para
América Latina}) drafted by the experts of the Latin American Institute for Tax Law (\textit{Instituto Latinoamericano de
Derecho Tributario} - ILADT) in the late 1950’s.

\textsuperscript{41} Our study backs up a project of drafting two model tax conventions for Latin America, which is being conducted
by an international research group (made up by legal experts and headed by Jacques Malherbe, Pasquale Pistone
and Heleno Taveira Tôrres) on behalf of the Latin American Institute for Tax Law (ILADT), whereas preparatory
studies have been presented at a seminar held in Montevideo on 11-12 May 2009 (on which see further in Mazza,
A., Pistone, P., (eds.), \textit{Reflexiones en torno a un modelo latinoamericano de convenio de doble imposición},
Fundación de cultura universitaria, Montevideo, 2009, in print). In particular, such project supports the conclusion
of a multilateral tax convention among Latin American countries, as well as a model bilateral tax convention for
assisting tax treaty negotiators of Latin America when concluding their treaties with HICs.
carried out in cases of shared allocation of taxing powers with a view to minimizing the tax burden in the State of source: such practices, better known as treaty shopping techniques, would simply disappear as a consequence of the exclusive allocation of taxing power to one single State. This would of course not remove the need to include measures to counter other type of abusive practices, though clear signs now indicate that this may be done by means of exchange of information, without giving rise to disproportionate reactions by the tax systems: all such type of clauses (anti-abuse, as well as broad clauses on exchange of information and assistance in collection of taxes) represent an essential tool for modern tax treaties, including the ones with developing countries.

This proposal could alter tax competition incentives, in particular as far as it concerns corporation tax rates. However, this phenomenon has to some extent already occurred after the US 1986 tax reform, reforms in other European countries, and the enlargement to (25, then) 27 States as a consequence of the more moderate budgetary needs of the new Member States, their intention to attract foreign capital and the obligation for all Member States to apply non-discriminatory tax treatment in corporate-shareholders relations. This gave rise to a generalized reduction in corporation tax rates throughout the European Union, bringing down the average rates well below 30%

One way to implement a move towards territorial taxation with respect to developing countries is contained in the current studies for a Draft Model Latin American Tax Convention on Income (hereinafter also: the Draft LATC). One way to balance out a surrender of taxing powers by HICs would be to give them exclusive taxing powers on passive income (dividend, interest, royalties and capital gains). However, debate carried out in the framework of the preparation of the Draft LATC have shown that this objective is simply unrealistic, because of the strong resistance, in particular within Latin America, to the idea of not taxing income produced on their territory. A possible solution to the problem would be to admit a system of revenue sharing in respect of such type of income, whereas developing countries tax such income at source and then pass on the revenue to HICs after retaining a portion. The mechanism is in substance similar to the one contained in the transitional regime set by Art. 11 of the EU Savings Directive and in the EU international tax agreements with Switzerland, Andorra, Liechtenstein, Monaco and San Marino, but the function would be partly different. Instead of being a mere instrument to keep track of cross-border flows of passive income, this mechanism would be a way to replace shared taxing powers with sharing the tax revenue from such income.

\[\text{\footnotesize{\textsuperscript{42}} Over the past couple of years the OECD has undertaken a strategy to put significant pressure on all countries to cooperate in order conclude tax treaties including broad exchange of information clauses. The effects of such policy can now be seen also in relations with countries that previously preserved banking secrecy and were considered tax havens.\}}\]

\[\text{\footnotesize{\textsuperscript{43}} The latter phenomenon is relatively well-known among legal experts, being the outcome of legal interpretation by the European Court of Justice. See ECJ, decisions 6.6.2000, case C-35/98, Verkooijen; 15.7.2004, case C-315/02, Lenz; 7.9.2004, case C-319/02, Manninen.\}}\]

\[\text{\footnotesize{\textsuperscript{44}} In the case of some old EU Member States, like for instance Germany, corporation tax rates have even been brought down to as little as 15%. This indicates that the traditional big gap between EU HICs and developing countries is no longer what it used to be some decades ago.\}}\]

\[\text{\footnotesize{\textsuperscript{45}} See \textcopyright{} Quiñones, N., “Establecimiento permanente e imposición exclusiva de la empresa en el Estado de la fuente”, in Mazz, A., Pistone, P., (eds.), \textit{Reflexiones en torno a un modelo latinoamericano de convenio de doble imposición}, Fundación de cultura universitaria, Montevideo, 2009, in print.\}}\]

\[\text{\footnotesize{\textsuperscript{46}} See further on this in Tenore, M., “Neutralidad e imposición de las rentas pasivas”, in Mazz, A., Pistone, P., (eds.), \textit{Reflexiones en torno a un modelo latinoamericano de convenio de doble imposición}, Fundación de cultura universitaria, Montevideo, 2009, in print.\}}\]
For other categories of income, whenever an exclusive allocation of taxing powers is not possible, relief for international taxation could be given by the State of residence in a way that does not produce compensatory effects, thus by either exemption or tax sparing. Partial tax sparing, as proposed in Section II of our work, could be a convenient way to avoid some of the drafting problems that such method has produced in some of the existing double tax treaties.

The adoption of the proposed rules on exclusive allocation of taxing powers and of methods for relieving double taxation other than foreign tax credit could indeed complicate the achievement of domestic the ability-to-pay principles. However, countries that use territorial taxation tend to also maintain their own ability-to-pay criteria with respect to personal taxation and passive income. That is, many countries that have opted for territorial taxation maintain their own home tax rate for income perceived to be particularly susceptible to tax avoidance (such as passive income) and for income deemed to be particularly important for domestic ability-to-pay concerns (such as personal taxation).

Achieving satisfactory arrangements for all countries is difficult and complex, especially in relations with developing countries. And taxation is no exception.
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