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BASIC CONCEPTS OF TAXATION

Abstract

Each state has the sovereign right to exercise jurisdiction over its own territory. However, double taxation belongs to a category that is regulated not only by national legal instruments but also by international ones. Therefore, it should be noted that the problem of preventing an unreasonable increase in the tax burden on taxpayers requires special attention in the implementation of an appropriate analysis. Double taxation was also a problem faced in the practice of the states during the past period. However, during that period, a certain practice was formed in the direction of regulating this issue. The double taxation problem is highly connected with the tax sovereignty. Tax sovereignty means that a state has the right to tax any individual or legal entity for their activity that must be taxed if there is any nexus. It is not rare in practice, for the same person to be subject to full tax liability in two or more states. Depending on the applicable laws, each of these criteria can lead to full tax liability.

Keywords: *international tax law, double taxation, economics, economic development, tax jurisdiction*

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İkiqat vergitutmanın əsas anlayışları

Xülasə

Hər bir dövlət öz sərhədləri daxilində yurisdiksiyaya malikdir və öz daxili işlərini həll etməkdə müstəqil və suverendir. Lakin ikiqat vergitutma sırf dövlətin daxili məsələsi ilə tənzimlənə bilən kateqoriya sayıla bilməz. Belə olan halda məsələnin beynəlxalq vergi hüququ çərçivəsində tənzimlənməsi və vergi ödəyicilərinin vergi yükünün əsassız olaraq artmasının qarşısının alınması üçün tədbirlər görmək lazımdır. Ötən dövr ərzində də dövlətlərin təcrübəsində ikiqat vergitutma problemi yaranmışdır. Lakin həmin dövrdə bu məsələnin tənzimlənməsi istiqamətində müəyyən təcrübə formalaşmışdı. İkiqat vergitutma problemi vergi suverenliyi ilə çox bağlıdır. Vergi suverenliyi o deməkdir ki, dövlət hər hansı fiziki və ya hüquqi şəxsə hər hansı əlaqə varsa, vergiyə cəlb edilməli olan fəaliyyətinə görə vergi tutmaq hüququna malikdir. Eyni şəxsin iki və ya daha çox dövlətdə tam vergi öhdəliyinə tabe olması praktikada nadir deyil. Tətbiq olunan qanunlardan asılı olaraq, bu meyarların hər biri tam vergi öhdəliyinə səbəb ola bilər.

Açar sözlər: *beynəlxalq vergi hüququ, ikiqat vergitutma, iqtisadiyyat, iqtisadi inkişaf, vergi yurisdiksiyası*

Introduction

To an international lawyer, the question posed above probably seems ridiculous. Of course international tax law is part of international law, just like tax treaties are treaties. But to an international tax lawyer, the question probably seems less obvious, because most international tax lawyers do not think of themselves primarily as international lawyers (public or private), but rather as tax lawyers who happen to deal with cross-border transactions. And indeed, once we delve into the details, it becomes clear that in some ways international tax law is different from "regular" international law. For example, international tax lawyers talk about residence and source jurisdiction, not nationality and territoriality − and as we shall see, the different names also carry different content. And while tax treaties are indeed treaties, they are concluded differently than other treaties (e.g., they are negotiated by the Treasury, not the State Department), are subject to different modes of interpretation (the Vienna Convention on the Law of Treaties ("VCLT"), the "Bible" of the international lawyer, is rarely invoked), and in the United States are subject to a rather peculiar mode of unilateral change, the treaty override.

International tax law regulates the tax law relations between taxpayers and states which include "foreign element". But no definition of international tax law is formulated in the legal norms or the doctrine. In general two relations that have critical importance for the state budget and the economy are regulated under the name of "the international tax law" (Avi-Yonah, 2004): First, taxation of residents of the country who have income from foreign activity. Second, taxation of foreigners that gain profit from their activity within the borders of country. One of the main problems arrises in the international tax law is originated from how to tax these activites of residents and non-residents (Arnold, 2013). Because their cross-border activities affects the interest of several countries and are subject different jurisdictions. In this case the questions arrise "who will be tax?", "which jurisdiction have the right to tax?", "which country's laws must the taxpayer obey?", "How will the interests of states be compromised?". As a result of the relevance of the mentioned problematic issues, the issue of double taxation has now become the main research object of international tax law. Improving economic relations, cross-border transactions, growing transnational investment and trade and the process of globalization demand reasonable adjustment which protects and secures the interests of states (Crow, 1999).

Although the issue of double taxation has a long history, it came to the fore in the 20th century (Radu, 2012). This is a manifestation of the globalization process, as we mentioned. Each state has jurisdiction within its own borders and is independent and sovereign in resolving its own internal affairs. However, double taxation cannot be considered a category that can be regulated purely by the internal issue of the state. Because in this case, we are talking about an activity that crosses the country's border (Aguzarova, 2020). When a subject participating in any economic relationship and a taxpayer carry out their activities outside the country of residence, from the aspect of the sovereignty of the country of residence or of the other country where the taxpayer carries out his activities, being taxed in both countries can have a strong impact on his activity. Of course, this can lead to the weakening of the activity of a legal or individual who is a participant in economic relations and, as a result, to the economic relations of the state and the weakening of the domestic economy. In this case, it is necessary to take measures to regulate the issue within the international tax law and prevent an unreasonable increase in the tax burden of taxpayers (Kysar, 2015).

Let's look at the history of double taxation. As we mentioned in the beginning, double taxation was also a problem faced in the practice of the states during the past period (Brooks, Krever, 2015). However, during that period, a certain practice was formed in the direction of regulating this issue. We are talking about tax treaties. It is necessary to mention in this part that the first tax treaties were signed 100 years ago. Continental European countries had come to such an agreement that they distribute the taxable earnings between themselves by allocating the tax right to only one state, making these earnings tax-exempt in the other. Until World War II, this was the method unanimously applied by all double taxation conventions between continental European states (Holmes, 2007).

The double taxation problem is highly connected with the tax sovereignty. Tax sovereignty means that a state has the right to tax any individual or legal entity for their activity that must be taxed if there is any nexus. This involves personal or objective nexus in itself. Personal nexus differs in respect of the individuals and legal entities. So, connecting factors for individuals are domicile, residence or citizenship (Lang, 2021). We must clarify the difference between domicile and residence. In general, the domicile and residence are the terms that mistaken as the same. The truth is that domicile means permanent home, while residence means temporary settlement. For legal entities, not these three elements, but the place of incorporation and the place of effective management are considered basic factors (Məmmədov, Musayev, Sadıqov, Kəlbiyev, Rzayev, 2010).

Two principles are taken into account during taxation. These are the principle of universality and the principle of territory (Ring, 2006). The mentioned principles, in turn, lead to full and partial tax liability. Let's explain it like this: under many domestic tax law systems, a person's worldwide income is taxed if a close personal connection exists between the taxable person and that state (universality principle). This is called full tax liability. However, if the connection is weak or consists only of objective factors, only the income earned in that state is taxed (principle of territoriality). This is called limited tax liability (12).

Nationality is usually understood as equivalent to citizenship. However, except for the United States, almost no other country in the world claims the right to tax its citizens on foreign source income when they live permanently in another country.

The United States insists on the right to tax its citizens on worldwide income no matter where they live. This was upheld by the Supreme Court in Cook v. Tait because of the benefits the US provides its citizens even if they live overseas. But the opinion is weak, its underlying rationale is doubtful (are these benefits really so great?) and almost no other country follows the rule. Thus, although international law seems to sanction the US practice (and the US has written it into all its tax treaties), it seems a dubious rule to follow, and it has been criticized by academics.

Instead, every country in the world (including the United States) has adopted a definition of nationality for tax purposes that is much broader than how nationality is commonly understood. That definition is residence, which usually implies mere physical presence in the country for a minimum number of days. In the U.S., physical presence for 183 days in a given year is generally sufficient to subject an individual to taxing jurisdiction on her world-wide income for that year.

Even fewer days suffice if added to days spent in the U.S. in the previous two years. Other countries follow a similar rule, although they sometimes supplement it with a "fiscal domicile" test that looks to less bright line factors such as location of principal abode, family ties, and the like. The two tests (physical presence and fiscal domicile) are also incorporated into tax treaties.

This definition is a remarkable expansion of the concept of nationality. I doubt there is another substantive area of international law in which nationality jurisdiction for individuals rests on so flimsy a ground as mere physical presence. In fact, because of this expansive view, it is easy to be subject to residence-based taxation by a country in one year and not in the next, and it is also easy for individuals to have dual tax residency. Elaborate rules are needed to address situations in which individuals move in and out of resident status from year to year (e.g., rules on deemed sales of their property when they leave), and to avoid dual residence double taxation.

Why has nationality based jurisdiction been so expanded in tax law? The reason is easy to see if one considers the implications of the relative ease of acquiring a tax haven nationality. If tax law followed the general international law rule and imposed world-wide taxation only on citizens, then a lot of U.S. citizens would acquire citizenship in some Caribbean tax haven jurisdiction and thereby avoid taxation on their foreign source income while living permanently in the United States. In general, living in a country for over half a year is considered a sufficient ground for worldwide taxation because of the presumed benefits derived from that country.

The residence rule is so widely followed and incorporated into so many treaties that it can be considered part of customary international law, even though it seems contrary to widely shared understandings of nationality (see part 4 below). It is thus appropriate for the United States to follow this rule. It is doubtful, however, whether the U.S. should continue to insist on taxing its citizens living overseas, especially since because of a combination of exemptions and credits (and enforcement difficulties) it collects little tax from them.

The nationality of corporations is a thorny issue, which comes up in other areas of the law as well. In general, corporations are considered nationals based either on the country in which they are incorporated (the U.S. approach), or the country from which they are managed and controlled (the U.K. approach), or both. Each approach has its advantages and disadvantages; the U.S. approach is the easiest to administer but also the most manipulable, as shown recently by so-called "inversion" transactions in which corporations shifted their nominal country of incorporation to Bermuda while retaining all of their headquarters and management in the United States. The U.K. approach is less easily manipulated but requires more administrative resources to police.

The interesting aspect of nationality jurisdiction for corporations in tax law is the gradual adoption of a rule that permits countries to tax "controlled foreign corporations" (CFCs), i.e., corporations controlled by nationals, as if they were nationals themselves. This rule originated with the United States. Because the definition of corporate nationality in the U.S. is formal (country of incorporation), it is easy for U.S. nationals (residents) who have foreign source income to avoid taxation on such income by shifting it to a corporation incorporated in another country, preferably a tax haven, where it can accumulate tax free. For example, Jacob Schick, the inventor of the Schick disposable razor, transferred his patent to it to a Bermuda corporation which accumulated the royalties; Schick later proceeded to retire to Bermuda, gave up his US citizenship, and lived on the accumulated tax-free profits.

To address this problem, the US adopted in 1937 a rule which taxed shareholders in "foreign personal holding corporations" (FPHCs). FPHC was defined as a foreign corporation controlled (over 50 % by vote) by five or fewer U.S. resident individuals, and whose income was over 60 % passive (since passive income was considered easier to shift than active income). Interestingly, at the time, the US considered it a breach of international law to tax a FPHC (a foreign national) directly on foreign source income; instead, it adopted a rule that taxed the US shareholders on a deemed dividend of the accumulated passive income of the FPHC. This rule can be compared to the personal holding company (PHC) regime adopted at the same time, which applied to domestic corporations and taxed them directly on their accumulated income at the shareholder rate (PHCs were used by shareholders to shelter US source income from the higher individual rate by earning the income through a corporation subject to tax at a lower rate).

The deemed dividend rule was upheld by Judge Frank of the Second Circuit without paying any attention to its international law implications.

And yet, it clearly represented a major expansion of US residence taxing jurisdiction, since taxing a deemed dividend is economically equivalent to taxing a foreign corporation directly on foreign source income. It could certainly be argued in 1943 that this rule was a breach of international law, just like Judge Hand's Alcoa decision (1945), which invented the effects doctrine, was likewise arguably a breach of international law.

The impact of the deemed dividend rule was greatly expanded when the Kennedy administration decided in 1961 to propose applying the same rule to all income of corporations that are over 50% controlled by large (10 % by vote each) US shareholders, i.e., to subsidiaries of US multinationals (CFCs). Ultimately, this resulted in the enactment in 1962 of "Subpart F" which applied the deemed dividend rule to certain types of income (mostly passive income) of all CFCs.

Again, there was no international law challenge to the deemed dividend rule. Instead, other countries began to copy the CFC regime: Germany (1972), Canada (1975), Japan (1978), France (1980), the UK (1984). Currently, there are 23 countries with CFC rules (mostly developed ones), and the number is likely to increase. Thus, it would seem that the CFC concept has arguably become part of customary international law, just like the expansion of territorial jurisdiction over international waters rapidly changed international law from the 1970s onward.

Even more striking is the fact that many of the countries adopting the CFC rule abandoned the deemed dividend idea, which can lead to significant difficulties in practice, in favor of direct taxation of the CFC- i.e., direct taxation of a foreign corporation on foreign source income just because it is controlled by residents.

Thus, the jurisdictional rule has been changing and no longer seems to require a deemed dividend. Indeed, the IRS itself has adopted this view, because it now believes that the PHC regime, as well as the older accumulated earnings tax regime, both apply directly to foreign corporations even though their effect is to tax the corporation on foreign source income. This is particularly striking for PHCs, because it was so clear in 1937 that the U.S. had no jurisdiction to tax foreign corporations on foreign source income that Congress did not bother to specify that a PHC could not be a foreign corporation (while at the same time adopting the parallel FPHC regime explicitly for foreign corporations). Now this oversight enables the IRS to argue that under the new understanding of jurisdictional limits, the PHC rules as well as the FPHC rules apply to foreign corporations.

Claiming that nationality jurisdiction applies to foreign corporations just because they are controlled by nationals is a striking departure from ordinary international law.

Compare, for example, the oft recurring disputes about the extraterritorial application of international sanctions. In both the Fruehauf (1965) and Sensor (1982) cases, the foreign courts explicitly rejected U.S. claims to require foreign subsidiaries of US multinationals to obey US sanctions aimed at China and the USSR, respectively. In Sensor, the Dutch court went through all the possible grounds for jurisdiction and explicitly found that none applied. It was clear that nationality jurisdiction did not apply even though the subsidiary was controlled from the United States.

What, then, enables the United States and other countries to expand nationality jurisdiction to subsidiaries in the tax area? The explanation is the “first bite at the apple rule”, adopted by the League of Nations in 1923. Under that rule, the source (territorial) jurisdiction has the primary right to tax income arising within it, and the residence (nationality) jurisdiction is obligated to prevent double taxation by granting an exemption or a credit. Thus, permitting the expansion of residence jurisdiction to CFCs does not harm the right of source jurisdictions to tax them first; residence (nationality) jurisdiction only applies as a residual matter when the source jurisdiction abstains from taxing. This still leads sometimes to complaints by source jurisdictions that the residence jurisdiction is taking away their right to effectively grant tax holidays to foreign investors, but even that is mitigated by the restricted application of CFC rules to passive income. In general, I believe this story is a good illustration of the growth of customary international law in the tax area. In the 1930-1960s period, there was a clear rule of customary international law that prohibited taxing foreign corporations on foreign source income. That rule was universally observed and was considered binding, as illustrated by the US avoiding an outright breach through the deemed dividend mechanism. However, once a lot of countries changed the rule by taxing CFCs directly, the US did not consider it binding any more, as indicated by applying the PHC regime to foreign corporations. The next step for the US, as advocated by many, would be to abolish the obsolete deemed dividend rule and replace it by a direct tax on the CFCs.

The right of countries to tax income arising in their territory is well established in international law. In fact, some countries (e.g., France) begin with the assumption that the only income they have the right to tax is domestic source income, although France and other territorial jurisdictions have long since begun to tax some income of nationals from foreign sources. And even countries that begin with worldwide taxation of nationals, like the US and the UK, in practice do not tax as heavily foreign source income.

The special problem of territoriality in the tax area is that the source of income is very difficult to define. In fact, most public finance economists would deny that it is a meaningful concept in the majority of cases. Think of a law firm in country A that provides advice on the legal implications of a merger of two multinationals whose parents are in countries A and B and whose operations are in twenty countries around the globe. What is the economic source of the law firm’s income?

Ideally, one could imagine a world in which all countries tax only on a nationality (residence) basis, and the only problem would be assigning residence to individuals (not too hard) and to corporations (quite difficult). But in practice, as long as countries desire to tax non-residents on domestic source income, as they have every right to do under international law, the problem of defining source would persist.

To some extent the problem has been solved by arbitrary rules embodied in taxtreaties (and that in my view may form part of customary international law) that define the source of various categories of income. For example, income from services is sourced where the services are provided (and not where they are consumed); dividend and interest income are sourced by the residence of the payor; capital gains are sourced by the residence of the seller; and so on. The difficulty then becomes deciding which category income falls into, which is sometimes very hard (consider for example how to distinguish between sales, services and royalty income when downloading software off the internet, buying it in a store, or receiving it in a pre-installed package on a PC).

In the case of multinationals, the sourcing issue becomes even harder because taxing them requires allocating the income of a controlled group of corporations among taxing jurisdictions. If tax authorities merely followed the form (regarding which subsidiary nominally earned the income from inter-group transactions), all income of multinationals would be booked in tax haven subsidiaries. A whole branch of tax law called transfer pricing is devoted to resolving this problem. In Part 4, I will return to this point, because it provides a good illustration of customary international tax law.

The main point here is simply that territoriality, which is a relatively easy concept to define in international law in general, becomes very hard when tax law is concerned.

And it may be a pity that international law makes it so easy to tax foreigners on a territoriality basis, although as long as we want to tax corporations, I suspect that source-based taxation is inevitable (since the residence of corporations is inherently more manipulable and less meaningful than the residence of individuals).

A taxable person can have close personal connections with two or more states. Under the tax laws of various states, for example, the person’s domicile is a connecting factor. In others, residence and citizenship are connecting factors. Depending on the applicable laws, each of these criteria can lead to full tax liability. Therefore, it is not rare in practice, for the same person to be subject to full tax liability in two or more states. This can lead to the levying of taxes on worldwide income in two or more states. The discussion has focused on double taxation arising from the taxation 11 of the same person concerning the same income in two or more states (juridical double taxation) (1). However, it is also possible for the same income to be taxed in the hands of different persons. This situation is known as economic double taxation.

Conclusion

The main reasons contributing to the occurrence of double and multiple taxations in international practice include imperfect tax laws of countries (in different countries, objects of taxation are regulated differently by tax legislation, and articles are interpreted ambiguously and multi-directionally); the lack of clear provisions on the offsetting of certain types of taxes paid by residents in another country; the application of different principles of taxation in interacting states (in one based on the principle of residency, in the other based on the principle of territoriality); taxation of the same income by tax payments simultaneously in different countries.

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