Aalto-yliopisto
Kauppakorkeakoulu

32E29000 European and international tax law

Introduction

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KEY ISSUES, CONCEPTS, PRINCIPLES

Why international taxation matters (maybe more than ever)?

- Borderless global economy
  - Digitalization
  - E.g. global business models of multinational companies (e.g. Apple, Starbucks, IKEA…)
  - Platform economy (Google, Amazon…)
  - Cross-border sales of services (e.g. games, cloud services etc.)
  - Emerging markets
  - Cross-border M&A
- In 2010s, flow of new tax regulation from the OECD and the EU…
- …but tax systems and tax revenues still mainly domestic…and countries compete in taxation…
- Other examples?

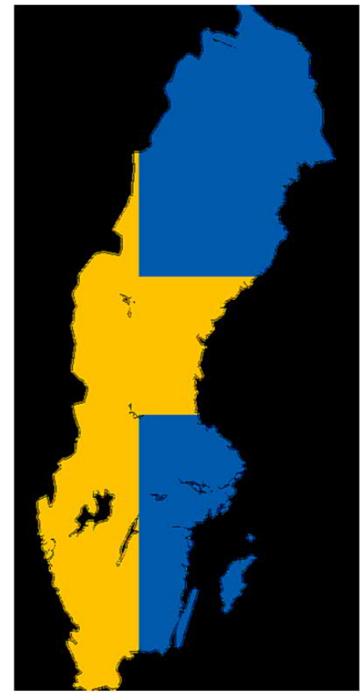
What is international tax law?

Finland

€ Cross-border income (income/corporate taxation) €

€ Cross-border supply of good / service (value added taxation, VAT) €

Tax object has connection to more than one state



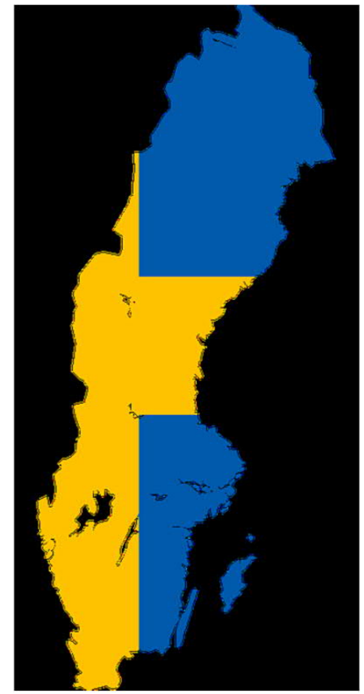
Sweden

What is international tax law?

€

Which of the states, or both, or none, tax the income?

At what tax rate?



Residence state

Source state

Key concepts

- Allocation of taxing rights on income between two countries
  - **Source country** is the country from which the income is received (”sourced”)
    - E.g. if a Swedish company pays a dividend, the dividend is sourced from Sweden
  - **Residence country** is the country in which the recipient of income is resident
    - E.g. if a company is established and registered in Finland, it is resident in Finland

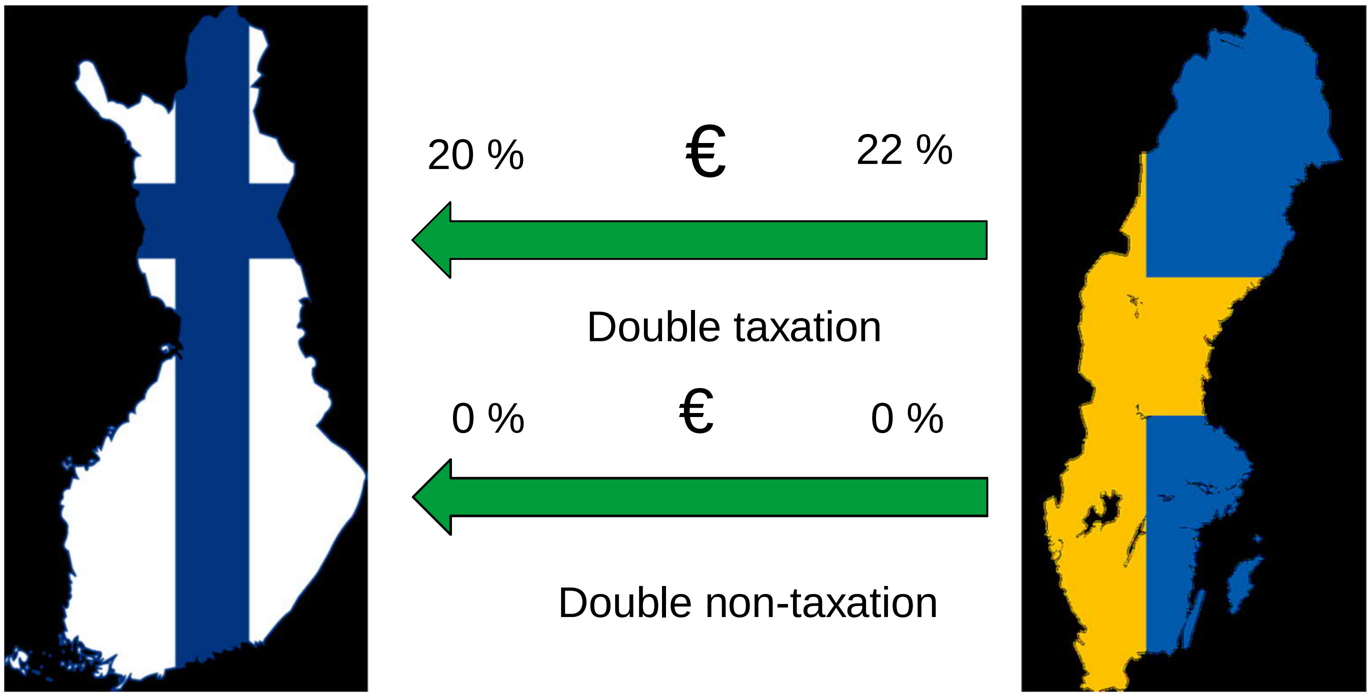
Residence country taxation

- Often applies principle of **worldwide taxation (unlimited tax liability)**
- Taxpayers that are ”resident” in the country may be taxed on all income – from domestic and foreign sources i.e. ”worldwide” – received
- Important to determine when a taxpayer is ”resident” in a country
- Taxation method based on assessment, i.e. liability to file a tax return and declare all income

Source country taxation

- Applies principle of **territorial taxation (unlimited tax liability)**
- Income sourced within the country, i.e. within its “territory”, may be taxed no matter whether received by a resident or non-resident taxpayer
- Important to determine when an income is sourced within a country
- Taxation method often “withholding taxation” i.e. the payer of income deducts the tax at source

What is international tax law?



Residence state
CIT rate 20 %

Source state
CIT rate 22 %

Key concepts

- **Double taxation**
  - The same income is taxed in more than one country
  - Origin: overlapping national (”sovereign”) tax systems
- **Juridical double taxation**: same taxpayer taxed more than once on the same income in different countries
- **Economic double taxation**: two or more taxpayers are taxed on the same income
  - Typically transfer pricing adjustments
  - Can also occur in domestic situations e.g. a company’s profits are first taxed at the level of distributing company and subsequently in the hands of shareholders as dividends

Example: Juridical Double Taxation

Residence State

Corporation tax on <u>dividend</u> on <u>Company A</u>

SAME INCOME

SAME TAXPAYER

Company A

Dividend

Source State

Withholding tax on <u>dividend</u> on <u>Company A</u>

SAME INCOME

SAME TAXPAYER

Company B

Example: Economic Double Taxation

Residence State

Corporation tax on interest 100
on Company A

Residence State

Transfer pricing adjustment
on Company B’s profits:
non-deductible
interest 50 → Economic double taxation

DIFFERENT
TAXPAYER

Interest 100

DIFFERENT
TAXPAYER

Company A

SAME
INCOME

Company B

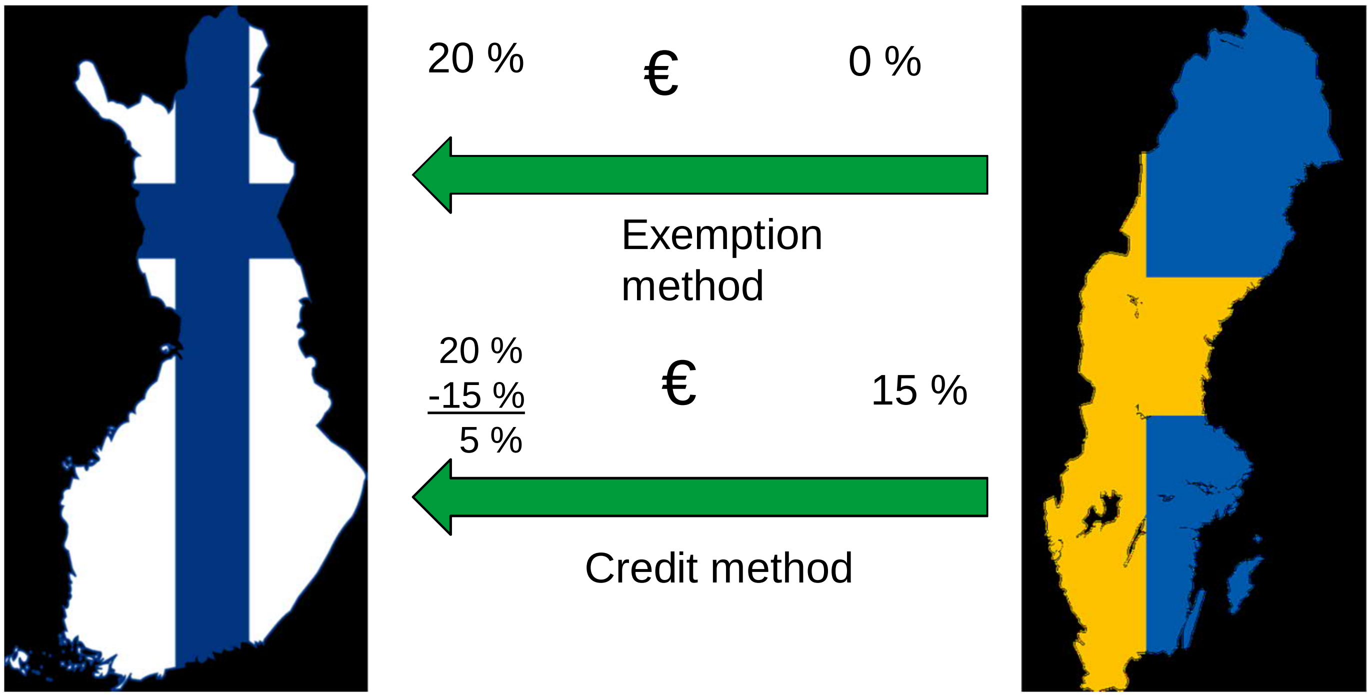
Key concepts

- **Double non-taxation or low taxation**
  - If the income is <u>not</u> taxed <u>anywhere</u>, or is taxed at a <u>very low rate</u>
  - Origin: differences in national tax systems and tax treaties, also tax competition between countries

Key concepts

- **Tax planning** = to minimize taxes legally, to avoid tax risks (**tax risk management**) such as double taxation
- **Aggressive tax planning** = to minimize taxes legally but morally unacceptable way
- **Tax avoidance** = to minimize taxes in an unacceptable way, against the purpose of law, often by using artificial arrangements → **anti tax-avoidance rules** are aimed to prevent tax avoidance
- **Tax evasion** = illegal minimization of taxes such as hiding income or information, possibly criminal
- The exact meaning of the above concepts may vary between countries

What is international tax law?



Residence state
CIT rate 20 %

Source state
CIT rate 22 %

Elimination of juridical double taxation

- The source state's and residence state's taxing rights must be coordinated
- Possible means
  - Domestic tax law
  - Bilateral tax treaties (”double tax agreement, DTA”)
  - EU law
- Possible solutions (methods)
  - Income is **exempted** in one country and taxed only in the other country (”exclusive taxing right”, ”exemption method”)
  - Income is taxed in both the countries but the tax paid in one country is **credited** in another country (”shared taxing right”, ”credit method”)

Elimination of juridical double taxation

- The method for the elimination of juridical double taxation depends on
  - the country in question (some countries prefer the credit method, whereas the others prefer exemption method)
  - the **income type** in question e.g.
    - Business income without a permanent establishment (PE)
    - Business income attached to a permanent establishment (PE)
    - Dividend
    - Interest
    - Royalty

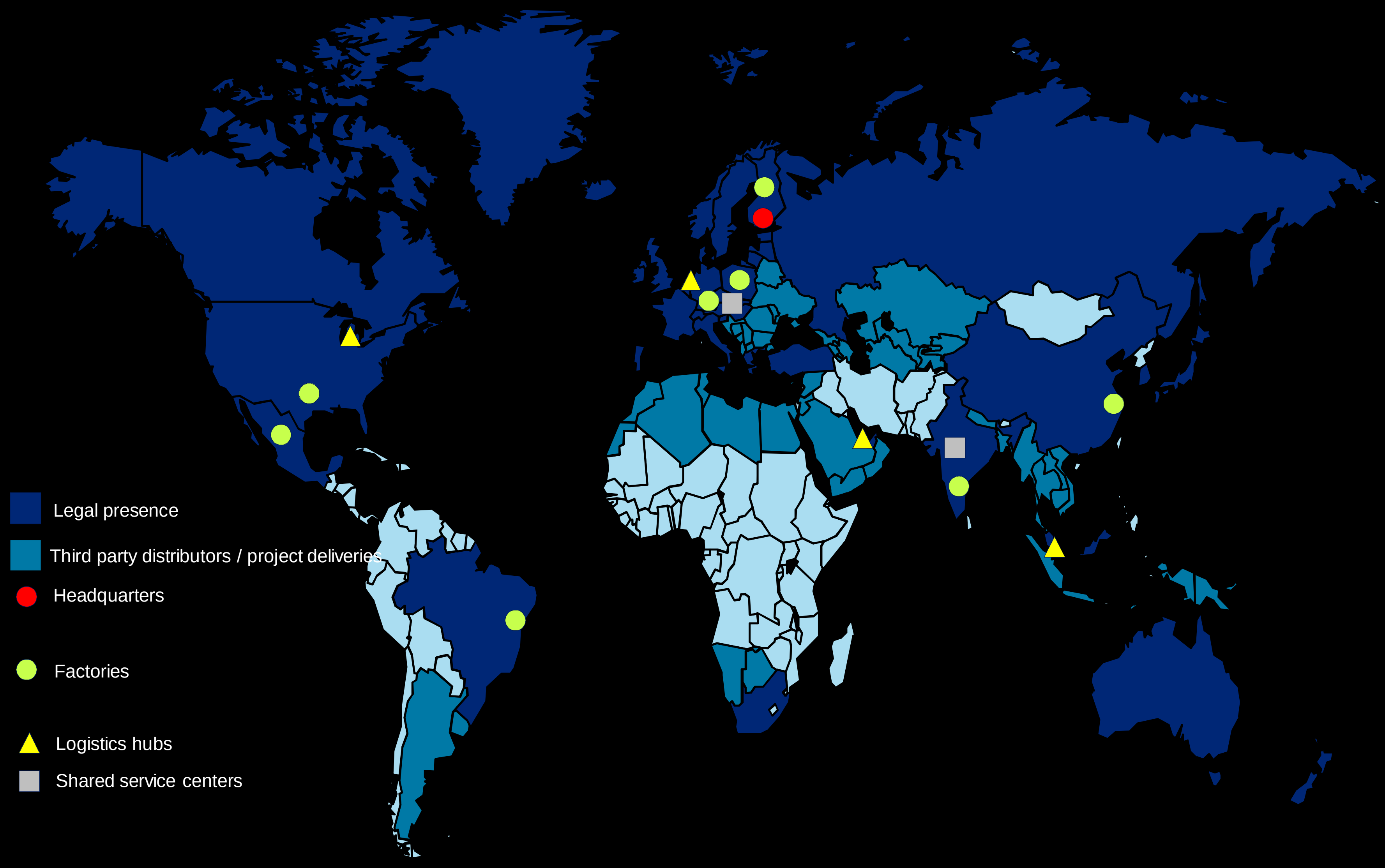
MNCs, transfer pricing and economic double taxation

- **Multinational companies (MNCs)** operate in group structures (i.e. parent company and subsidiaries)

  → companies belonging to the same group may have legal presence and be tax resident in different countries and

  → companies have transactions with each other (e.g. contract manufacturing, intra-group sale of services, financing)

  → transactions result in cross-border income flows and supply of products and services between group companies → 60-70 % of annual world trade


Legal presence
Third party distributors / project deliveries
Headquarters
Factories
Logistics hubs
Shared service centers

MNCs, transfer pricing and economical double taxation

- International taxation of groups of companies is based on
  - **Separate entity principle →** each company has own taxable profit
  - **Arm's lenght principle →** each company must calculate its taxable profit based on terms and prices that would have been agreed with unrelated parties (i.e. companies not belonging the same group)

    → there are different transfer pricing methods to determine the arm's lenght prices

    → OECD Transfer Pricing (TP) Guidelines provide international standard for the application of the arm's lenght principle

MNCs, transfer pricing and economical double taxation

- When residence countries of two or more companies do not agree on the same arm's lenght price, there is "**transfer pricing dispute**" and risk of economic double taxation
- Transfer pricing disputes involve significant economic values up to several billions of euro / dispute
- Transfer pricing issues have gained huge significance since mid-2000 and are at the core of MNC's tax management
- Don't miss the workshop on transfer pricing disputes on Thu Jan 31 13.15-15.30 (Guest lecturer Petteri Rapo / Alder&Sound)!

What is international tax law?

tax deduction → non-taxable

no taxing right → tax exemption

tax exemption ← tax deduction

Finland

Classification conflict, disparity

Luxembourg

International double non-taxation

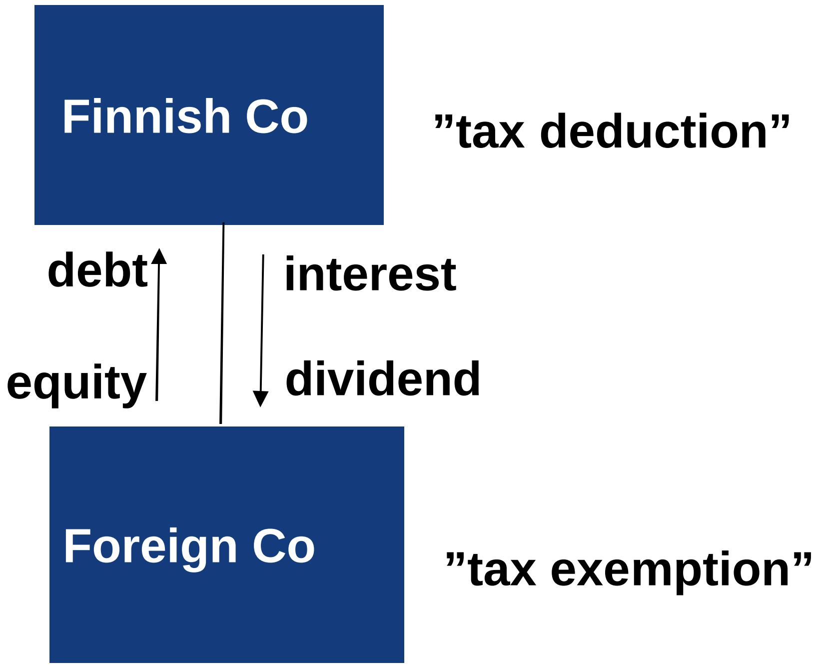
- Disagreements (**classification conflicts**) or differences in tax treatment (**disparities**, **mismatches)** between source and residence state may lead to double non-taxation
  - Source state grants tax deduction, residence state does not tax → **hybrid mismatch**
  - Source state may believe that a tax treaty precludes it from applying its taxing rights under domestic law but the residence state neither taxes the income → **classification conflict**

International double non-taxation

– Source state grants tax deduction, but the residence state applies tax incentive that exempts the income or taxes it at a very low rate (**disparity)**
– The same deduction may be made twice in two different states (**douple dip, hybrid mismatch)**

Example. Hybrid mismatch

Foreign company gives a hybrid instrument which is treated as equity in foreign country and as debt in Finland



Elimination of double non-taxation

- Focus of international tax coordination in the 2010s at the OECD and EU level is to prevent double non-taxation and low taxation arising from aggressive tax planning or tax avoidance
- Possible means
  - Domestic tax law
  - Bilateral tax treaties (”double tax agreement, DTA”)
  - EU law

Elimination of double non-taxation

- Possible solutions
  - **Anti-tax avoidance rules**
  - Increased **transparency** between taxpayers and tax administrations as well as between tax administrations of different countries by means of **exchange of information**
  - Limiting **harmful tax competition**

INTERNATIONAL TAX SYSTEM: SOURCES OF LAW

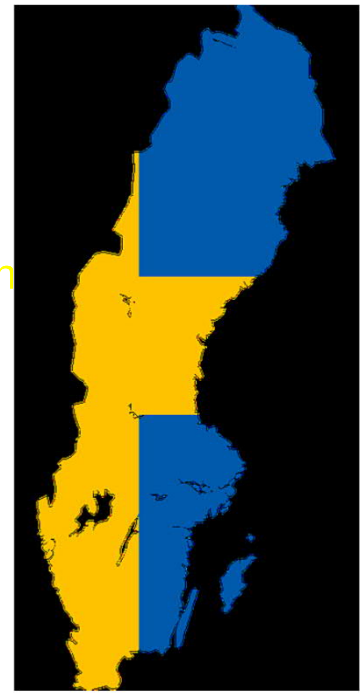
Sources of international tax law?

Domestic tax law of Finland

Domestic tax law Sweden

Tax treaty between
Finland and Sweden
(Nordic tax treaty)

European union (EU) law



Residence state

Source state

Domestic (international) tax laws

- Domestic tax law of each country dealing with cross-border tax situations
- Main objectives
  - Create taxing rights
  - Protect national tax base
- Determination of resident and non-resident taxpayers
  - Who is tax resident (subject to unlimited tax liability) and who is non-resident (subject to limited tax liability)?
  - When is a permanent establishment (PE, all income attached to a PE subject to unlimited tax liability) created?

Domestic (international) tax laws

- Determination of domestic and foreign source income
  - Domestic-source income taxable for both residents and non-residents
  - Foreign-source income taxable only for residents
  - Method for avoidance of double taxation of foreign income → also covered by rules of tax treaties

Domestic (international) tax laws

- Measures to protect national tax base
  - Anti tax-avoidance rules e.g.
    - **Controlled foreign company (CFC) rules** to prevent sheltering of income in low taxed subsidiaries
    - **Interest deduction limitation rules** to limit erosion of tax base due to deductible interest payments
    - **Exit taxation rules** to prevent transfer of assets abroad without paying tax

Domestic (international) tax laws

- **Hybrid rules** to avoid use of mismatches in tax laws and tax treaties of different states
- **General anti avoidance rule (GAAR)** to generally prevent tax avoidance

– Transfer pricing and documentation rules

Tax treaties (double tax agreements, DTA)

- Concluded between different states to
  - eliminate double taxation
  - prevent tax avoidance
- Only binding between the signing states
  - usually two states = bilateral
  - Exceptionally more than two states = multilateral
    - Nordic Tax Treaty covers Finland, Sweden, Denmark, Norway and Iceland
  - Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI)
    - Special type of multilateral convention that modifies existing DTAs
    - Covers 85 countries/jurisdictions

Tax treaties (double tax agreements, DTA)

- Tax treaty overrides domestic tax law
  - It limits taxing rights based on domestic tax laws → **”golden rule of tax treaties”**
  - In some countries (e.g. USA) domestic law may override tax treaty (treaty override)
  - Tax treaty brings benefits to taxpayers
- Scope is limited to income taxation taxation (e.g. VAT is not in the scope)

Tax treaties (double tax agreements, DTA)

- **OECD Model Convention** as a basis for common understanding
  - Finnish DTAs are based on the OECD Model Convention
- **OECD Model Commentary** as a main source of interpretation for DTAs
- **OECD Transfer Pricing Guidelines** ("TP Guidelines") as a main source of interpretation for the application of the arm's length principle in transfer pricing

European Union (EU) law: Primary law

- Treaty on the Functioning of the European Union (TFEU)
- Fundamental freedoms of movement: goods, workers, establishment, services and capital
- Creates rights (benefits) for companies and individuals
- Case law of the European Court of Justice of the EU (CJEU) on application of primary law on domestic tax laws and tax treaties
- EU law **overrides** domestic tax laws and tax treaties

European Union (EU) law: Secondary law

- Corporate tax directives
  - Parent-Subsidiary-Directive
  - Interest-Royalties-Directive
  - Merger Directive
  - Anti-Tax Avoidance Directive (ATAD)(as of 2019)
  - Dispute Resolution Directive (as of 2019)
- EU value added tax (VAT) directives include detailed rules on the common VAT system applicable in the EU member states

European Union (EU) law: Secondary law

- The aim of the directives is to improve the functioning of the EU common market by **harmonising** and **coordinating** national tax laws of EU member states
- Directives **affect** and **override** national tax law → must be **implemented into national tax law of each EU member state**
- Case law of the European Court of Justice of the EU (CJEU) on the interpretation and application of EU directives

HOW TO FIND INFORMATION?

How to find information: EU and OECD web-sites

- EU home page: http://europa.eu.int
- EU legislation: http://eur-lex.europa.eu/en/index.htm
- European Commission (Taxud): http://ec.europa.eu/taxation_customs/taxation/index_en.htm
- European Court of Justice: http://curia.europa.eu/en/transitpage.htm
- Direct Tax Court Cases: http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/tax_law/legal_proceedings/court_cases_direct_taxation_en.pdf

How to find information: EU and OECD web-sites

- OECD: www.oecd.org
- OECD Glossary of tax terms: http://www.oecd.org/ctp/glossaryoftaxterms.htm
- OECD Model Tax Convention and Commentary on Income and on Capital 2017: http://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm
  - Can be read (but not downloaded) online free of charge
  - Please note that the course literature includes the previous version (2014), but both the versions may be used as reference material for the course

How to find information: Finnish web-sites

- Finnish tax laws: www.finlex.fi
- Ministry of Finance: www.vm.fi
- Finnish Tax Administration: www.vero.fi
- Finnish tax treaty database: http://www.vero.fi/fi-FI/Syventavat_verohjeet/Kansainvaliset_tilanteet/Voimassa_olevat_verosopimukset
- Finnish Supreme Administrative Court: www.kho.fi

How to find information: other sources

- International Bureau of Fiscal Documentation: www.ibfd.org
  – Extensive databases on international taxation. Unfortunately Aalto University does not have subscription to databases but e.g. library catalogue may be used free of charge
- All major international tax consulting firms (EY, Deloitte, KPMG, PWC) offer comparative tax information (i.e. corporate tax guides) and studies on their web pages (try google ☺)
- Marjaana Helminen's international and EU tax law books