The Taxation of International Income Flows: Issues and Approaches

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Foreword

Since its foundation in 1983, the Institute of Policy Studies has had an active programme of studies on tax policies. The introduction of GST as a major step towards changing the balance of direct and indirect tax is only one of several major policy initiatives to which Institute studies have contributed. Another is the whole area of business taxation, especially the issue of integrating company and shareholder taxation. The process of tax reform continues, partly because of the momentum created as one reform throws up deficiencies and anomalies elsewhere in the tax system, and partly because there is still a long way to go before the taxation system is compatible with the government's objectives of efficiency and equity.

An area which is already one of particular concern and to which even more importance will be attached in the near and medium-term future is the formulation of appropriate policies for taxing income earned by New Zealand residents overseas and income earned in New Zealand by residents of other countries. The Institute was glad that Professor Bird was able to accept its invitation to survey the issues raised by these topics. Professor Bird has an enviable reputation in international tax issues in Canada and elsewhere, and has been employed as a consultant in many countries. He was therefore ideally placed to bring current international thinking to bear on the New Zealand situation. The Institute is grateful to people in both the private sector and the public sector who provided Professor Bird with opportunities to test his ideas against practices in New Zealand.

The conclusions of this study are those of Professor Bird. The only criterion for publication by the Institute is its assessment of the intrinsic merit of the research reported. Nevertheless, the Institute seeks to sponsor work which is likely to be of value to those responsible for determining policy, whether directly or through their role in creating a climate of public opinion which facilitates the making of difficult choices. It is confident that Professor Bird's study satisfies all these requirements.

G R Hawke
Director

Acknowledgements

A brief study cannot review in detail all the principles and practices relevant to the taxation of international income flows, let alone apply this general analysis to the specific case of New Zealand, particularly when the author is not a lawyer and has only the most superficial knowledge of the New Zealand tax system.

The aim of the present paper is therefore the much more limited one of using the extensive international literature as a basis for setting out and appraising some of the key problems that must inevitably be confronted by a small, open economy like New Zealand as it reforms its business tax system. I am most grateful to the Institute of Policy Studies for asking me to undertake this interesting task and for facilitating its accomplishment in a relatively brief time. Paul Bevin, who initially asked me to write this paper, and Peter Hall, who made the necessary administrative arrangements, deserve special thanks, as do the numerous people in Wellington and Auckland, in both private and public sectors, who gave generously of their time to discuss these complex matters with me. I can only hope that the results of my enquiry, preliminary as they are, will prove of some use to them and to New Zealand, as it proceeds with the difficult but essential task of adapting its tax system to the realities of the modern world.

Richard M Bird

1 The Problem

Problems of Tax Reform

Taxation is the accepted means of distributing the burden of financing government activities. Any tax system thus tends to assume a quasi-constitutional status. Major reforms in this central fiscal institution generally mean the redistribution of this burden among various groups in society, and are almost invariably difficult and controversial. As a rule, they can be accomplished only within the limits of political acceptability, that is, to the extent that they do not imperil those in power at the time. Within this broad constraint, however, would-be tax reformers in developed countries have traditionally assumed that governments can do more or less as they wish. In recent years, the much-heralded rise of the 'informal' or 'underground' economy has given rise to doubts about the validity of this proposition. Much more important in most countries, however, are the limits imposed on tax reform by the openness of the economy to international capital movements.

Major tax reforms in open economies, if they are to achieve their intended objectives, must be drawn up in full awareness of the possible losses through 'informal' (uncontrolled) international channels. Moreover, it is often critical to the acceptability of domestic reforms to avoid creating the public perception that the rich and powerful can escape taxes easily via the offshore door. Those who would establish a tax system that is both politically acceptable and productive of revenue must therefore craft it carefully to fit an international context which is neither of their own making nor under their control. This is clearly a very difficult task.

International Tax Policy: Getting it Right

The effectiveness of international tax policy in this respect depends upon getting each of three critical conditions right.

1. The policy must be properly formulated — an extremely difficult task, requiring a judiciously complicated balance of specific and general rules.
   Moreover, since, as noted later, it is in fact impossible ever to achieve the 'right' policy, given the differing systems in other countries, these rules are likely to change frequently.
2. The policy must be properly implemented — a task which requires a good deal of information which is neither easy nor cheap for governments to obtain.

Indeed, most of the information must come from the taxpayers themselves, since by definition their jurisdictional span exceeds that of the government which is attempting to tax them.

3. Those who breach the policy must be identified, charged, convicted, and punished appropriately so as to make the expected cost exceed the expected gain from international tax avoidance.

   As with the second condition, to a large extent the odds are again on the side of the taxpayer, especially given the usual dislike of the public sector for losing in court and the complexity of the facts in international tax cases.

The actual international tax policy in place in any country thus reflects not only the theoretical complexity and international bargaining involved in formulating policy in this area with respect to the first condition, but also the severe practical constraints imposed by the other two conditions. These conditions in effect mandate a certain degree of voluntary co-operation, and hence of bargaining between taxpayers and the authorities, as the *sine qua non* of effectively taxing international income flows. The task of getting international tax policy right is clearly formidable.

The New Zealand Context

These problems have existed in New Zealand and elsewhere for a long time. They have come to the forefront here in the last few years for two principal reasons.

1. New Zealand has in a short space of time moved from being one of the most closed economies in the developed world to being one of the most open. The complete abolition in late 1984 of exchange controls after over forty years of operation has undoubtedly been the single most important action producing this result, but a number of other moves toward financial deregulation have also contributed to the present situation[1]. Not only is there now no government regulation of private capital outflows and almost none of capital inflows, but the government does not even have any reliable information on the size and nature of such flows.
2. There have been major tax reforms in recent years such as the introduction of a broad-based value-added tax (GST, or Goods and Services Tax), the restructuring of the personal income tax rate schedule, and the elimination of many tax incentives, while still others — notably the introduction of a full imputation system — are in train. Despite the absence of hard data, there seems to be a widespread perception that, more or less simultaneously with the opening of the economy and this new wave of tax reforms, there has been a substantially increased outflow of New Zealand capital. Moreover, although there is no evidence as to the causes of this outflow, let alone its effects, there is also clearly considerable concern about its implications for both the public acceptability and the revenue productivity of New Zealand's business tax system. Not only is the effectiveness of reform in this area suspect, but there is also some danger that flagrant and well-publicised incidents of international tax avoidance will reduce the social consensus underlying government policy just when it is most needed to

support socially painful but apparently necessary adjustments to the realities of the modern world.

The stakes at issue are even higher than this, however, for New Zealand's prosperity continues to depend to a substantial extent upon its attractiveness to foreign investment. Taxes on such investment, for example, still constitute over a third of all company tax revenues. The new importance of capital exports in New Zealand should thus not obscure the continued importance of such capital imports — not least, the continued retention and reinvestment in New Zealand of the profits of the mature subsidiaries that account for the bulk of direct foreign investment in New Zealand. Tax policy with respect to such investment must continue to perform the delicate balancing act of inducing foreigners to contribute their capital resources to New Zealand while simultaneously obtaining for New Zealanders the maximum feasible share of the returns accruing to such resources.

At the same time, tax policy must also take on the new, high-profile task of taxing capital outflows in a way that will be both fair and efficient. The terminology here needs some explanation. *Fairness* in this context basically means 'acceptable' — both to the general public, which means blocking flagrant tax avoidance, and to the relevant taxpayers themselves, which means not pressing too hard on legitimate international business transactions as well as leaving New Zealand-based taxpayers competitive with those in other countries. *Efficiency* in this context is perhaps even more a term of art. One version of efficiency *(capital-import neutrality)* is implicit in the business perception of 'fairness' already mentioned. Another *(capital-export neutrality)* is often assumed to require such common features of international taxation as the foreign tax credit and certain aspects of tax treaties. Yet another *(national welfare maximisation)* is usually presumed to be the objective of economic policy, including tax policy. Various tax measures may thus be judged to be simultaneously more or less 'efficient', depending upon which of these standards is adopted. (Each of these concepts is discussed briefly in Chapter 2.)

There is only one clear statement of policy towards foreign investment on record in New Zealand[2], but it was made some years ago and related only to foreign investment in New Zealand, not New Zealand investment abroad. Judging from the actions of recent years, current policy may perhaps be described as more consistent with the maximisation of international than of national welfare, at least in the short-run, in the sense that unconstrained international capital flows in both directions seem to be basically acceptable, provided such outflows do not impinge unduly on the sanctity of the domestic tax base. This position is of course open to criticism by those who are more concerned with maximizing national welfare[3]. Tax policies towards foreign investment may also quite legitimately be used, like any other policy, to achieve such non-fiscal objectives as improved overall relations with this or that country. Nevertheless, given the complete uncertainty in the literature as to whether or not investment abroad is nationally as beneficial as investment at home, a policy of neutrality towards such investment, rather than favouring or discouraging it, is quite defensible. As seen below, however, current tax policies are not neutral in this

sense but favour investment overseas, and this feature, combined with the need to protect the domestic tax base, suggests that some policy changes are needed.

The International Context for New Zealand

At the same time, recent changes abroad in the tax systems in New Zealand's principal sources of investment — the United States, the United Kingdom, and Australia — suggest that other changes too may be needed if New Zealand is not to lose out in its role as a country still dependent on retaining and preferably extending its access to foreign capital. And finally, not only are tax policies affecting capital imports linked to those affecting capital exports, but both are relevant to what is perhaps the central tax issue in New Zealand today — the relationship of personal and business income taxes. Unless international capital flows can be properly taxed, in an important sense no business income can be effectively taxed; if business income is not effectively taxed, the personal income tax in effect amounts to little more than a wage tax; and the case for a progressive wage tax is, to say the least, a shaky one at best. To a certain extent, then, the appropriate taxation of international income flows is an essential ingredient in the effective progressive taxation of incomes in small, open economies like New Zealand. The link between these two points may be somewhat obscure, but that it exists is beyond argument, and the fact of its existence is yet another reason for paying close attention to some of the apparently esoteric issues raised in the present paper.

Models for Analysis

One basic difficulty in discussing the taxation of international income flows is that any attempt to provide a formal model of the process quickly becomes so complex that strong — and often implausible — assumptions are needed to produce clear results. Small, apparently insignificant, features of the tax law may produce major differences in outcomes. The same feature in a domestic tax law may also produce quite different results in conjunction with the tax systems of different partner countries, which means that the 'optimal' tax policy is different in every case — and hence unattainable by a country that attempts to maintain some consistency in its policies. In any case, two — or more — countries are simultaneously playing the same 'game', which makes attaining an optimal solution even more unlikely either in the abstract or in practice. Finally, recent analyses attempting to model more explicitly the finance function of enterprises operating across international borders have cast doubt upon the validity of even those few conclusions that seemed to emerge clearly from some of the earlier analysis[4].

Another complication in principle, and perhaps to some extent in practice, is that there are often considered to be important differences in the reactions of 'direct' and 'portfolio' investors to particular tax policy changes. Portfolio investors (those exerting no control over their investment except the right to exit) are usually presumed to be extremely sensitive to tax-induced changes in the rate of return. Those who invest abroad directly, however, are often assumed, in accordance with the standard

theory of multinational enterprises, in effect to be extracting some sort of 'quasi-rent' and hence to be less susceptible to tax influences, at least once they are committed[5]. Too much should not be made of this distinction, however. The importance of the finance function in multinational firms is such that many of them may be more usefully considered to be acting as a sort of internal capital market than as any sort of directly productive enterprise. This argument lends some credence to the concern that relatively minor tax changes in a country like New Zealand may lead to New Zealand-based multinationals relocating abroad — although the extent to which this should be a cause for concern is not explored here — as well as to the relocation of real production by finance-driven multinationals — which clearly is a matter of great policy concern. On the whole, however, what has to be said in the end is that we simply do not know which model constitutes the best description of New Zealand's circumstances, nor are we ever likely to do so with much certainty. The same uncertainty applies to many other aspects of the taxation of international income flows.

Summary of Content

In the circumstances, the best advice for small countries like New Zealand would seem to be to advance cautiously in the international area and to be prepared to react flexibly to changing circumstances. The balance of this paper in effect attempts to put some specific content into the general concerns sketched above. Chapter 2 first discusses some of the currently prevailing rules of the international tax game, while Chapter 3 surveys even more briefly the major relevant features of current New Zealand law. Chapter 4 then considers a number of separate questions, the answers to which may provide a system of taxing international capital flows in New Zealand. The brief concluding chapter brings the major points together.

Notes to Chapter 1

1. It has sometimes been suggested that the Closer Economic Relationship (CER) Agreement with Australia has created pressure to harmonise New Zealand's taxation system with that of Australia additional to that inherent in the economic relations between the two countries in any case (Richard Vann (1986). *Eliminating the Double Tax on Dividends — Legal and Practical Issues,* Institute of Policy Studies, Wellington. If 'harmonisation' is understood to mean "make more uniform", as is usually the case, this argument is not persuasive in economic terms — although it may still be politically relevant. See Richard M Bird (1987). 'Tax Harmonization in Federations and Common Markets', Unpublished paper, International Institute of Public Finance, Paris.
2. *Foreign Investment in New Zealand* (1981). Supplement to Reserve Bank of New Zealand Bulletin.

3. Richard M Bird (1986). 'International Aspects of Tax Reform in Australia', Unpublished paper, Australian Tax Research Foundation, Sydney; and Ian Harrison (1986). 'Inflation, Taxation and International Capital Flows. Some Results for a Small Country', Unpublished paper, Reserve Bank of New Zealand.
4. Contrast, for example, the traditional national welfare argument for allowing only the deduction of foreign taxes (Peggy Musgrave (1969). *United States Taxation of Foreign Investment Income,* Harvard Law School International Tax Program, Cambridge, Massachusetts) with the analysis of Julian S Alworth (1985), ('A Cost of Capital Approach to the Taxation of Foreign Direct Investment', Unpublished paper, Bank for International Settlements, Basle), which shows the ease with which this policy can be offset by relatively minor shifts in the financial structure of particular subsidiaries of multinational firms.
5. Richard M Bird (1986b). 'The Interjurisdictional Allocation of Income', *Australian Tax Forum* 3 pp 333-354.

2 The International Context

An International Tax System?

Strictly speaking, there is no such thing as an international 'system' of taxing inter-country income flows[1]. Since no law limits the tax jurisdiction of any country, each country can adopt whatever rules it wishes to tax income, whether it crosses international borders or not. Whether it can enforce the rules it adopts is, of course, quite another matter. Over the course of the past century, as the role of state activity expanded in almost every country, the importance of income taxes as a means of financing that activity has also expanded. At the same time, the increasing economic interdependence of developed countries inevitably required them to adapt their tax systems to accommodate the reality of increased international income flows. In few, if any, countries was this international dimension of income taxation developed in close conjunction with the overall structure of domestic tax policy, however. Instead, the key tax features affecting international income flows have either been:

1. accidental in the sense that policies adopted for domestic reasons have important international implications (such as interest deductibility);
2. 'add-ons' intended to cope with one or another specific problem as it becomes apparent (such as limitations on interest deductibility); or
3. adaptations of features developed in other countries for their own reasons (such as the indirect foreign tax credit).

In short, the present taxation of international income flows in most countries consists of a patchwork structure which often makes little sense in terms of the presumed objective of most national economic policy, including tax policy, namely, the maximisation of national welfare.

The international tax 'system' has thus developed more by chance than by design, although it is usually portrayed as purposeful and coherent. Rules about such matters as the foreign tax credit and arm's length pricing are seen as achieving laudable aims like 'locational neutrality' and 'international equity'. In terms of their historical development, however, the prevalence of such policies reflects not so much purposive design as the dominance of the interests of large capital-exporting nations, notably the United States, in the post-World War II era when the present rules were shaped and codified under the aegis of such organisations as the Organisation for Economic Co-operation and Development[2]. Nevertheless, although the international tax criteria conventionally cited are more an attempt to rationalise the policies found in the real

world than a guide to those policies, it is worth discussing them briefly before setting out what seem the key aspects of the present international tax environment.

International Tax Criteria

In the eyes of many economists the first among tax criteria is 'neutrality', largely because neutrality provides a useful benchmark in assessing the distortion (loss of welfare) attributable to taxes on capital income. Capital will be allocated efficiently, other things being equal, if the relationship between pre-tax marginal returns on alternative investments is maintained after tax. Despite the apparent simplicity of this criterion, however, it gives rise to some complexity in the international realm. International tax arrangements may in principle, for instance, *either* establish a situation in which domestic investors experience no tax distortion with respect to their decision to invest at home or abroad *or* one in which residents investing abroad are not discriminated against vis-a-vis other investors in the host country.

Capital-Export Neutrality

The former condition, called 'capital-export neutrality', is as a rule the only one considered relevant by economists. From the point of view of any one country, the interaction of domestic and foreign taxes will be capital-export neutral if domestic investors are indifferent between domestic and foreign investments with equal pre-tax yields. In principle, such capital-export neutrality is established when a capital-exporting country taxes its investors' worldwide income on a current basis at the 'residence' rate with full and immediate credit for taxes paid abroad. If a country maintains capital-export neutrality in this sense, its capital will be allocated efficiently throughout the world — a contribution to world economic efficiency.

Capital-Import Neutrality

The second situation mentioned above is sometimes called 'capital-import neutrality'. A tax system is said to be capital-import neutral if domestic investors and foreign investors receive equal after-tax yields from an identical investment. In other words, capital-import neutrality places domestic investors and foreign investors on an equal tax footing with respect to investment in a particular country. This condition can be achieved if capital-importing nations tax income from foreign-owned investment at the same rate as domestically-owned investment, as is usually the case — provided, however, that the capital-exporting nation *exempts* foreign-source income from taxation. It is presumably this version of neutrality that businessmen have in mind when they assert that the change from an exemption to a credit system will make them less 'competitive' abroad. Since such 'competitiveness' may generally be secured, however, only by a policy which, by definition, reduces the efficiency with which national capital is allocated and hence reduces the level of *both* national and world-wide income, few tax analysts have looked kindly upon the exemption system.

Foreign Tax Credit and Neutrality

As mentioned above, in principle a foreign tax credit will result in capital-export neutrality provided:

(1) all taxes on foreign-source income are fully creditable,
(2) all foreign-source income is taxed (and credits allowed) on a current basis by the residence jurisdiction, and
(3) the structure of taxes applied to corporate income is essentially the same everywhere.

In practice, each of these three necessary conditions is always lacking, to a greater or lesser degree. The attainment of capital-export neutrality is thus compromised by limitations on the tax credit, by the deferral of taxes on foreign-source income, and by the effects of different degrees of personal-corporate tax integration in various countries. Leaving the last point aside for the moment, consider the other two conditions for the achievement of neutrality.

To restrict potential revenue loss, an upper limit is invariably imposed on the foreign tax credit, usually by stipulating that it can be no more than the amount of residence tax liability otherwise due on foreign-source income. Foreign investments are thus taxed at the higher of the rates charged by the source and residence jurisdictions. If the source rate (including any withholding tax) exceeds the residence rate, a tax bias thus prevails against capital exports (although this is strictly the case only if the residence jurisidiction adopts the per country limitation method, that is, does not allow the pooling of taxes and income from different foreign sources).

On the other hand, deferral generally establishes a much more important bias *in favour of* investment abroad. 'Deferral' means that the residence tax liability is not in fact incurred until the earnings of a foreign investment are repatriated to the residence of the investor. The longer the repatriation of foreign-source earnings is delayed, the closer to zero becomes the present value of the residence tax liability.

National Welfare Maximisation

In principle, nevertheless, it is clear that the tax distortion of capital-export decisions may be eliminated unilaterally by a capital-exporting country through a full foreign tax credit system (albeit of a type which no country actually has, or perhaps can have). The capital-exporting country necessarily pays a fiscal price — it gives up tax revenue — to promote capital-export neutrality. But why should it do so? A capital-exporting country may quite reasonably take a narrower view of 'neutrality' and consider that tax system to be best which is 'neutral' in the sense of equating the returns from investment abroad (net of foreign taxes) with the gross-of-tax returns of investment at home. If, as most tax reform analysis assumes, a country should be concerned with maximising its national welfare rather than some even more abstract notion of 'world' welfare, it should in principle not allow the crediting of foreign taxes at all. Rather, it should treat such taxes simply as costs of doing business abroad, and thus allow only their deduction, as for any other cost.

Equity Criteria
Moreover, in addition to efficiency, equity considerations are not only relevant to, but often dominant in, tax policy analysis and discussion. The deduction approach, for example, is consistent with a narrow national view of interpersonal equity which takes into account only domestic taxes on net income and not total (domestic plus foreign) taxes as does the 'international equity' approach of the credit. More importantly, the distribution of tax revenue between capital-exporting and capital-importing countries, or what may be called the 'inter-country' sharing of gains from foreign investment, is obviously a major issue in the international context—indeed, probably *the* major issue in international tax policy.

As a practical matter, of course, problems of allocation (of international investment) and distribution (of the returns from international investment, including tax revenue) cannot really be separated. Tax arrangements that achieve a particular degree of allocative efficiency simultaneously determine a corresponding distribution of fiscal revenue. To put this point in another and perhaps more relevant way, the nature of present international tax arrangements can probably be better explained in terms of 'inter-country' sharing than in terms of achieving either a 'national' or an 'international' efficiency goal. The widespread use of the policy of crediting foreign taxes, for instance, is probably as much a result of the fact that capital importers have the first crack at taxing investment income as it is of aspirations to the loftier objective of world-wide allocative efficiency.

Unilateral Tax Rules
Consideration of the various criteria commonly found in the literature thus does not do much to advance understanding of international tax problems. An alternative approach might be to consider the various levels at which each country must make decisions about how to tax international income. At least seven such levels may be distinguished:
(1) jurisdictional principle;
(2) nexus;
(3) co-ordination rules;
(4) definition of tax base;
(5) allocation of tax base;
(6) rates; and
(7) enforcement.

The following discussion focuses on the first and third of these aspects, but all are clearly important in determining the final outcome, and all are touched on at some point in this paper.

Source Principle
In practice two basic jurisdictional rules have developed: the *source principle* and the *residence principle*. Under a 'pure' *source principle*, residents and non-residents alike are taxed only on income that arises from sources within the country. This

principle may appear to provide an easy way to avoid the possibility of two countries subjecting the same income flow to unduly heavy taxation, provided of course that each country adopts precisely the same rules for determining the source of income. In practice, however, the definition of 'source' involves considerable technical difficulties, and there are frequently conflicting source rules in different countries. More importantly, the whole idea of the source principle is inconsistent with the fundamental concept of a comprehensive income tax as a means of taxing individuals in accordance with their ability to pay, since it excludes from taxable income the income received by residents from outside the country. Countries whose residents have significant investments abroad have therefore tended to adopt some sort of 'residence' principle, at least in part for this reason.

Residence Principle

Under the *residence principle*, the burden of taxation depends not upon the geographic source of the income but upon the residence of the taxpayer. As with the source principle, however, simplicity disappears when it comes to applying the residence principle in practice. Worldwide taxation of residents obviously requires, for example, a definition of 'residence'. For corporations, two basic rules are generally used to determine residence: the *place of incorporation* and the *seat of management* tests. Under the former rule a corporation is regarded as a resident of the country in which it is incorporated, while under the latter, it is deemed to be a resident of the country from which its policy is actually controlled. Since different countries have different rules, it is perfectly possible for a corporation to be 'resident' in two jurisdictions simultaneously.

A potentially important difference between these two residence rules concerns the taxation of the foreign subsidiaries of domestic corporations. Under the place of incorporation test, such a subsidiary is not regarded as a resident corporation. Taxation is therefore normally postponed until profits are repatriated to the parent company: as mentioned above, this practice is known as 'deferral'. Under the seat of management rule, however, the income of subsidiaries may obviously be taxed currently if desired, though in fact few countries do so, except in unusual circumstances. Moreover, in practice, even countries using the place of incorporation rule (such as the United States) may deny deferral to the income of a subsidiary, and consequently impose tax on resident shareholders currently, in order to reduce the danger of tax avoidance through manipulation of profits so that they appear to arise in low-tax countries (tax havens). As a rule, however, foreign subsidiaries (not branches) are treated as though they are completely separate entities with profits (however defined by a country's tax law) in principle being divided as if the different components of the firm were trading at arm's length. In practice, as discussed below, this approach gives rise to considerable problems which have led countries which take the enforcement problem seriously to develop many specific guidelines for the division of income and expenses among subsidiaries and parents.

Taxation of Non-residents

Looking at the other end of international income flows, most countries using the residence principle also tax the income derived by non-residents from sources within their territory. The extension of tax jurisidiction to non-residents in this way in virtually every country gives rise to two important issues:

1. the manner in which the income of non-residents is taxed by the country of source;
2. the treatment by the country of residence of income that has already been taxed in the country of source.

1. *Taxation in each source country is of course governed by its own laws.* Any country is free in principle to choose whatever rules it wishes to use for determining the source of income, determining who is subject to its taxes — the usual nexus (or connection establishing liability to tax) is the existence of a 'permanent establishment' — calculating taxable income, and applying the tax rate. In practice, however, a degree of uniformity appears to have emerged, at least among developed countries, with respect to the taxation of corporate-source income. Generally, a subsidiary of a foreign corporation is taxed quite separately from its parent and in the same way as a purely domestic corporation, thus satisfying what is usually called the 'nondiscrimination' principle. In addition, however, almost all countries levy a tax on dividends paid by subsidiaries to their foreign parents at statutory rates often ranging up to 30 per cent, though sometimes reduced by tax treaty to 5 or 10 per cent. Although usually called a 'withholding tax', this tax is of course quite different from most withholding in that it generally constitutes the final determination of tax liability by the levying country: it is thus not a prepayment of the domestic income tax, but a substitute for it. Similar taxes, often at similar rates, are also levied on such other transborder flows as interest, royalties, and management fees, at least partly in recognition of the extreme fungibility of multinational finances. Moreover, some countries levy related taxes on foreign branch profits (which are usually taxed currently in the residence country).

2. *If one country taxes profits on the residence principle and the same profits are also taxed in the source country, the result is often referred to as 'international double taxation'* — though in practice the result may equally well be international undertaxation! Merely permitting the deduction of foreign taxes (like any other cost of earning income) from taxable income before computing the domestic tax due on income derived abroad would clearly be insufficient to provide full relief from such 'international double taxation'. Unless the foreign tax rate is zero, the combined tax burden, foreign and domestic, would always be higher on subsidiary income with this 'deduction' approach than on income from domestic operations.

Two main unilateral approaches have been developed to eliminate or alleviate this result:

1. the exemption of foreign-source income from tax in the residence country;
2. the provision by the residence country of credits for taxes paid in the source country.

In addition, the attainment of such relief is a principal rationale for the network of tax treaties that has been developed.

1. *The exemption method* as used in countries such as the Netherlands simply exempts from domestic tax the income derived by residents abroad, usually on condition that the income has been taxed (at any rate) by foreign countries. Thus, under this approach, a resident corporation is subject only to the *foreign* corporation tax, regardless of whether the foreign tax rate is higher or lower than the domestic rate. The exemption method is clearly consistent with capital-import neutrality as defined earlier but is not efficient in either national or international terms.

2. *The credit method,* in contrast, imposes the normal domestic tax rate on income derived from abroad, but at the same time provides, within limits, a credit for foreign taxes (including withholding taxes) against domestic tax. The usual *credit with deferral,* however, as opposed to the exemption, creates a new incentive to defer repatriation of profits and hence may actually reduce the benefits accruing to the residence country from investment abroad. *A credit without deferral* (the system usually applied to branches) while still inferior on 'national' efficiency grounds to deduction, would clearly be superior to exemption: deferral, however, makes the choice considerably less obvious, even in principle. In practice, given the relative ease with which many multinational enterprises can avoid taxes in any case through financial restructuring, the case is not so clear: the deduction system may, for example, increase borrowing in the host country to finance investment, while the credit without deferral may be more neutral as between different forms of finance[3]. In the end, the main advantage of the usual foreign tax credit system, and perhaps ultimately the reason for its adoption in many countries, is that it is internationally respectable and hence presumably more acceptable — and less vulnerable to retaliation — than the grab for national advantage represented by the deduction system.

If the credit is thus viewed as a sort of 'half-way' house between the unacceptable exemption and the unattainable deduction, however, it seems clear that the more limited the credit is, the better off a country will be. Measures that limit the credit by country, by source of income, or by time period (through allowing no carryover), while clearly bad from the point of view of 'world efficiency', may thus be quite acceptable moves from the more important point of view of national efficiency and ensuring the residence country a 'fair share' of the gains from foreign investment. Of course, moves to obtain a larger share are likely to provoke retaliation from foreign countries in various ways, which is one reason why bilateral tax treaties have developed to support such unilateral methods of dealing with international income flows.

Tax Treaties

Since unresolved conflict may cause potential gains from international economic integration to be lost, such conflict in effect creates its own incentive for reconciliation through some form of international tax co-ordination. Owing to the international diversity in national economic circumstances and comparative advantage, however, the gains from international economic integration, and especially the distribution of such gains, may differ significantly among different pairs of countries. Neat general solutions are thus unattainable. As a result, reconciliation of conflict in international tax matters is usually achieved either unilaterally along the lines already discussed or through bilateral negotiation formalised in a tax treaty. The body of international tax law thus consists largely of an array of tax treaties, each of which enshrines elements of compromise struck in particular economic and political circumstances.

At least three important considerations underlie the negotiation of bilateral tax treaties:

1. allocative considerations;
2. distributive considerations; and
3. what may be termed the environmental functions of such international agreements.

Allocative Considerations

One focus in designing a treaty, for instance, should in principle be to increase the efficiency of the international allocation of factors of production. This treaty objective is sometimes referred to as 'elimination of double taxation' but, in principle, it is broader than that. As noted above, what has come to be the accepted aim is to co-ordinate national tax systems so that taxation in one country or another does not sway decisions to invest at home versus abroad. The objective is thus capital-export neutrality with respect to international investment.

The 'excess burden' of a tax is what economists call the output lost through tax-induced distortions in the economy. Such loss is a pure 'deadweight' loss resulting from misallocation of resources. It does not involve one sector losing while another gains. There are no distributional trade-offs with excess burden. A 'neutral' tax, one that does not distort economic decisions, creates no excess burden. In the international setting, excess burden is the loss of aggregate output attributable to distortions that are the international economic consequences of national policies. Such misallocation of resources results internationally from barriers to trade and restrictions on international factor movements. Since tax treaties address the latter, they are in principle intended at least in part to move overlapping tax systems closer to neutrality, to reduce international excess burden, and to increase economic efficiency. A tax treaty between two countries can of course not redress the internal inefficiencies of domestic tax policy. At best, in line with the international neutrality principle, a tax treaty may seek to ensure that the interaction of national tax systems does not further distort investors' choice between investing at home or abroad.

Distributive Considerations

A second major issue in international tax negotiation concerns the sharing between capital-exporting and capital-importing countries of tax revenue from foreign investment. It is inevitable when dealing with concepts such as distributional equity that the analytic basis is even more value-laden and arbitrary than in the case of allocative efficiency or neutrality. As noted earlier, however, tax arrangements that achieve a particular degree of allocative efficiency simultaneously determine a corresponding distribution of fiscal revenue.

If two countries export capital to each other, tax distortions are minimised all-round — the international perspective — if each adopts either the credit or the exemption method. In fact, tax treaties usually include a reciprocal arrangement of one or the other method for every category of foreign-source income. By adopting a foreign tax credit, for instance, a capital-exporting country acknowledges the capital-importing country's first tax claim on earnings of capital, including foreign-owned capital, in its jurisdiction. Indeed, capital-importing countries typically take a large bite, recognising that as long as their taxes are credited against liability in the capital-exporting country, they can capture tax revenue with no marginal allocative consequences (at least within certain limits). The distribution of tax revenue from foreign investment will then approach equality if the stocks of foreign investment are equally distributed and if, in each country, tax rates are approximately the same. When these conditions are not met, however, the outcome is not likely to be so nicely balanced.

Tax treaties typically include clauses regarding nondiscriminatory tax treatment of foreign and domestic capital. In practice, equal treatment in this sense is achieved if all capital within each nation is taxed by the same domestically specified rules and rates. Aside from any discriminatory elements in this respect, specific features of domestic tax systems such as tax incentives restricted to domestic investment are generally kept off the treaty agenda to avoid encroaching on domestic fiscal sovereignty. This approach is also consistent with an apparently widely held international tax convention regarding overlapping tax jurisdictions: the priority to tax is source country first, residence country second. Accordingly, treaties generally focus on establishing equal withholding tax rates on interest, dividends, and other earnings on foreign capital because such taxes are levied at the border and are thus, by definition, discriminatory.

Environmental functions

A third purpose of tax treaties, after their allocative and distributive functions, is to establish a degree of fiscal stability in the environment within which international business takes place. The fact that national tax jurisdictions are in principle limitless, coupled with indisputable national sovereignty in tax matters affecting individual nations, creates a situation in which destructive international conflict or capricious manoeuvring could easily arise. Tax treaties establish formal compromises in areas of international jurisdiction overlap. Furthermore, provisions for the review and renegotiation of tax treaties help reconcile unforeseen problems as they arise.

Investors shy away from uncertainty, and tax administrators want security in tax administration. As a formal agreement between nations, a tax treaty spells out some of the rules of the game for all the players, investors and countries alike.

For business, reducing tax risk lowers a barrier to international investment. Therefore, in this respect, the 'environmental' function of a tax treaty is consistent with the 'allocative' function. Eliminating nondiversifiable risks arising from international tax variations is a necessary, although not a sufficient, condition for the efficient international allocation of capital.

For tax administrators, the explicit terms of a treaty reduce the tasks of tax administration. In particular, the interaction of two governments dealing with one tax base may help solve administrative problems beyond the scope of any one government alone. Tax treaties generally provide a legal mechanism for exchange of information (occasionally including simultaneous tax audits) necessary to ensure compliance and minimise evasion, although in fact their success in this respect has so far been, at best, limited.

Tax Treaty Interpretation

Because tax treaties cannot possibly deal with all potential difficulties, most modern treaties contain 'competent authority' clauses which allow issues to be addressed on an *ad hoc* basis insofar as they cannot be resolved by the explicit terms of the treaty. The most frequent and difficult matters pertain to the interpretation of rules defining the allocation of income between source and residence countries (and sometimes involving a third country as well). In dealing with such problems, the competent authority mechanism assures the taxpayer of all intended benefits in a tax treaty, at least in principle. The goal of providing relief to the taxpayer is thus accomplished in part by international agreements which preserve each country's fiscal sovereignty, accommodate differences on a reasonable basis and, in the process, achieve equitable results, at least in principle.

The willingness of countries to restrict their tax jurisdiction by treaty essentially depends upon the reciprocal nature of the agreement and their desire to encourage international investment. When investment flows between countries are approximately equal, or when there is a strong desire to encourage the free movement of capital, there is a strong incentive to negotiate tax treaties. The less these conditions hold, the less strong the incentive to make a deal. Basic imbalance in the position of small and large countries may make an acceptable division of tax base and agreement on general rules difficult. Moreover, since international tax affairs are never static, it is also not surprising that new issues constantly surface even when a treaty is concluded.

The US, for example, has become very worried recently about 'treaty shopping' — a term applied to one aspect of the unending search by tax practitioners for soft spots in international tax law. The scope for international tax planning by firms, which in principle is constrained by legal definitions, rules, and tax rates, is in practice broadened considerably by the fungibility of international capital, by the inherently

imprecise and arbitrary nature of many accounting methods, and by the difficulties of international tax auditing and verification. The importance of international tax planning through third-party manoeuvres is evidenced, for example, by the swollen investment position in tax havens. To ensure that the New Zealand-US treaty does not create additional opportunities for circuitous tax planning which could be costly to the US Treasury, an anti-abuse provision with respect to third party use was therefore inserted in Article 16 of the Treaty.

Fiscal Relations with Trading and Investment Partners

US concern about the potential use of tax treaties by third parties may reflect its recognition that its interests no longer automatically lie on the side of the most open and tax-free flow of international investment funds. From the perspective of a large capital-importing country, the optimal level of foreign investment is generally less than the unconstrained market-determined level. A tax on the earnings of foreign-owned capital will therefore generally be in the interest of such a country.

The defence of the tax system in an open economy is unquestionably a national prerogative, and the opportunities for taxpayers to shift income internationally to avoid tax must be monitored vigilantly. No set of bilateral tax treaties can be expected effectively and permanently to compartmentalise international capital flows, thus eliminating the scope for intermediate manoeuvres involving third parties. In the complex real world, such bilateral compartments will be as arbitrary as they are insecure. International investments frequently involve pools of capital and a maze of intermediaries with a holding company serving as a link. The principles and application of international source rules are insufficiently precise to provide an unambiguously 'correct' allocation of the cost of highly fungible international intra-corporate finance. Strict rules to exclude third — or fourth or fifth — parties are likely to create administrative nightmares, with no assurance of improved efficiency. Even if a heavy-handed approach succeeded in blocking certain international financial manoeuvres, desirable international investment flows might well suffer in the process.

In addition to such general considerations, a final important aspect of the international context within which a country such as New Zealand must formulate its international tax policy concerns the constantly changing policies of its more important trading and investment partners. Two recent developments in a number of these countries are of particular interest in this connection. In the first place, the US, the UK, Canada and soon Japan, have all lowered their nominal corporate income tax rates significantly. While Australia, like New Zealand, has moved the other way, it too may well be influenced by this trend in the near future. Secondly, the US, and to a lesser extent the United Kingdom, have recently taken steps to tighten up their foreign tax credit systems, particularly with respect to the crediting of taxes on interest income. Both of these moves have obvious potential implications for New Zealand's current policy of taxing capital imports through a high corporate tax rate and non-resident withholding taxes. The latter, like the increasing use of specific allocation

rules for deductions in the United States[4] and the adoption of variations of controlled foreign corporation legislation in a number of countries[5] may also influence what New Zealand can or should do with respect to taxing capital exports. This is discussed further in Chapter 4 below.

Notes to Chapter 2

1. Large parts of this chapter are taken from Richard M Bird (1986b). 'International Aspects of Tax Reform in Australia', Unpublished paper, Australian Tax Research Foundation, Sydney. I owe some of these points to earlier work with my colleague, Donald Brean, at the University of Toronto.
2. See especially, OECD (1977). *Model Double Tax Convention on Income and on Capital*, Paris.
3. Julian S Alworth (1985). 'A Cost of Capital Approach to the Taxation of Foreign Direct Investment', Unpublished paper, Bank for International Settlements, Basle.
4. Joseph H Guttentag (1986). 'Basic International Tax Planning under the Tax Reform Act of 1986', Unpublished paper, Tax Executives Institute, St Louis.
5. Brian J Arnold (1986). *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Foundation, Toronto.

3 The New Zealand Context

Options for New Zealand

There are four possible approaches New Zealand might take to the formulating of an appropriate international income tax policy:

1. Faced with the difficulty of containing international tax avoidance and the dubious national benefits of continued capital outflow, it may opt for a return to a system of full exchange control. To the extent that such controls are effective, the connection between international and domestic tax policy will be severed, and the tax system can be developed according to domestic needs. However, it seems that this option, although attractive on narrowly fiscal grounds, will not in fact be chosen. For one thing, it is thought New Zealand gains more from capital inflows than from capital outflows. Moreover, the spur of international competition, painful though it may be, is considered necessary to prevent the economy from lapsing into stagnation.
2. A second, quite different, approach would be to welcome, not deplore, the present extreme openness of the New Zealand economy to the international capital market, and indeed to capitalise on it by making New Zealand a haven for nervous capital from around the world. Such features as its stable political situation, its well-developed communications and financial systems, and its location in the world's time zones, when coupled with a tax system which exempts income flows such as dividends and which levies relatively low taxes on outflows to non-residents, would seem to put New Zealand high on any list of the world's attractive tax havens. International banking centres and New Zealand-based multinationals would presumably flourish in such an environment. A carefully designed structure of corporate and non-resident withholding taxes might even lead to some of this money being put to productive use within New Zealand. Since countries as developed as the Netherlands follow essentially this approach to international tax policy, such an idea is by no means as ridiculous as it may sound. Nevertheless, it appears that this option too will not be chosen, perhaps for fear that any gains from haven status will be swamped by the loss of international respectability.
3. It is possible to carry on more or less as at present, relying on such general anti-avoidance provisions as those in Section 22 and especially Section 99 of the present income tax act to protect the revenue[1]. There are at least two major problems with such a 'do-nothing' strategy, however. First, as noted in Chapter

1, the pressure of international tax avoidance is greater than ever before and is apparently mounting steadily. Even if these general provisions were adequate when backed by exchange control, which in itself is arguable, they are unlikely to be able to stem the tide today.

Secondly, a major problem with the general anti-avoidance approach is that precisely because it is so general it creates unnecessary and undesirable uncertainty in the application of the law and also provides such wide discretion to the tax authorities that courts have often proved most unwilling to countenance the strict application of these powers. The first of these problems may to some extent be dealt with by a system of advance rulings such as is presently being contemplated. Although the administrative costs of adopting such a path should not be underestimated, the gains in increased certainty will almost certainly prove worthwhile[2]. As for the second problem, even in countries such as the US and, recently, the UK, in which courts have at times proved willing to look through the 'veil' of corporate structure and to focus on the economic consequences of actions rather than their legal form, it has proved necessary to buttress general anti-avoidance powers by numerous provisions aimed at specific abuses. Indeed, experience in countries where tax systems have come under international tax avoidance pressure strongly suggests that sole reliance on general anti-avoidance provisions to cope with problems of international income flows is not a promising approach. Such provisions are, of course, necessary; but they are not, in themselves, enough.

4. The fourth and final approach to international tax problems, the development and continual refinement of specific guidelines and specific anti-abuse provisions, thus appears in the end to be the path that New Zealand, like most developed countries, will sooner or later choose to follow. The next section of this paper therefore discusses some of the major issues that have to be dealt with if this strategy is adopted. First, however, it will be useful to set out very briefly a few of the relevant features of the existing New Zealand income tax system.

New Zealand's Income Tax System

The present corporate tax on resident companies is 48 percent, the same as the top rate of the personal income tax. Non-resident companies are taxed at 53 percent, presumably in lieu on any additional New Zealand tax on their dividends. There is no tax on capital gains even at the company level. Moreover, inter-company dividends, including those received from abroad, are exempt from company tax. A system of full imputation is to be introduced in 1988, although the details are not yet available.

Taxes are levied on the basis of residence, with New Zealand residents being taxed on global income, and all New Zealand source income being taxable in New Zealand. Companies are residents if they are incorporated in New Zealand or have their head office, or more precisely, "centre of administrative management", in New Zealand.

The precise meaning of the latter expression is slightly cloudy, but it seems clear that the ability to change residence for tax purposes lies in the hands of the company (provided it is not incorporated in New Zealand). While there are also some unclear elements in New Zealand source rules, on the whole they bend the other way in the sense of encompassing, at least in principle, some business income that would not normally be considered to be New Zealand source income. In particular, except for treaty countries, a business need not have a permanent establishment in New Zealand to have some of its income apportioned to New Zealand under New Zealand rules, provided its business is "partly" in New Zealand.

New Zealand introduced a foreign tax credit in 1962, but the credit is limited only to taxes paid directly by the New Zealand taxpayer (e.g. withholding taxes) that are analogous to the New Zealand income tax. No credit is extended to any underlying corporate tax. In addition to this unilateral relief, New Zealand has also signed bilateral tax treaties with twenty countries, mainly its major developed-country trading partners such as the US, the UK, and Australia. As a rule, these treaties follow the general OECD model, incorporating clauses specifying non-discrimination, lower reciprocal withholding taxes, and the exchange of information. The basic rates of withholding tax are 30 percent on dividends (15 percent for treaty countries), 15 percent on interest (often 10 percent in treaties), and 15 percent on royalties, broadly defined. New Zealand does not distinguish between participatory and portfolio investments in either its law or its treaties.

Legislation introduced in 1987 has placed the tax treatment of gains and losses from foreign exchange transactions on an accrual basis, thus reducing the obvious opportunities for manipulation in the previous realisation system. In contrast to some countries, however, New Zealand has as yet not developed any specific rules or guidelines on the allocation of deductions, such as interest, between foreign-source and domestic source income. Instead, the approach followed is one of fact, or the 'tracing' of particular loans to particular expenditures - an enterprise that seems doomed to endless difficulties by the fungibility of money. New Zealand also has no thin capitalisation rules, nor does it have any rules specifically aimed at tax haven operations. Its principal means of dealing with international tax avoidance is Section 22 of the Income Tax Act which is aimed at transfer-pricing operations between related companies, and has reportedly been used administratively a fair amount. Recently, it was announced that more teeth would be put into this provision by requiring such companies to provide information on certain offshore transactions to the tax authorities, subject to special penalties for non-compliance. No details are as yet available on this[3].

Notes to Chapter 3

1. All references to New Zealand law in this paper are based mainly on John Prebble, *The Taxation of International Income*, Butterworths, Wellington, forthcoming.

2. John Prebble (1986). *Advance Rulings on Tax Liability*, Institute of Policy Studies, Wellington.
3. See, for example, Hon. R O Douglas (1986a). *Budget 1986*, Government Printer, Wellington; and Hon. R O Douglas (1986b). 'Government Moves Against Use of Tax Havens', Mimeo, 22 December.

4 The Taxation of International Income

The preceding discussion has been by way of introduction to the following description of some of the issues on the taxation of international income flows currently facing New Zealand. In another sense, however, the value of the present paper may lie more in the preceding attempt to put these various issues in proper perspective than in the following specific suggestions as to what may or should be done with respect to this or that particular feature of the tax system. The suggestions range from the trivial to the bold. They vary considerably both in importance and in the extent to which they have been thought through in detail by anyone anywhere, let alone in the specific context of New Zealand. What the ideas in this section have in common, however, is that they are all firmly grounded in the general analytical framework developed earlier.

That framework may perhaps be summed up in three propositions:

1. the development of an appropriate system of taxing international income flows is critical to the maintenance of an effective income tax;
2. the task of developing such a system is an exceptionally complex one which can never be accomplished perfectly or once and for all in any country but requires constant attention;
3. even though what can be done is at best inevitably going to be rather arbitrary and unsatisfactory, it is nevertheless critically important that it be done, and done quickly.

Foreign Investment in New Zealand

One point which was emphasised earlier was the continued importance of foreign investment in New Zealand. In 1984, for example, 29.8 percent of the reported net after-tax profit of companies operating in New Zealand went to firms with 25 percent or more of their voting share capital controlled abroad; in 1983, the comparable figure was 34.8 percent[1]. These overseas companies distributed 45.2 percent of their profits as dividends in both years, presumably to non-resident shareholders, which suggests that revenues from the non-resident withholding tax on dividends should have been $23 million in 1983 and $28 million in 1984. Total collections from non-resident withholding taxes in each of those years were actually $43 million, with most of the balance presumably coming from taxes on interest payments, although similar taxes are levied on royalties and 'know how' payments. Comparable calculations for earlier

years, when the distribution ratio was a bit lower, suggest that $18 million and $14 million should have been assessed for 1982 and 1981 respectively, when total non-resident withholding tax collections were $36 and $24 million respectively. When added to the substantial profits assessed to such companies — $287 million in 1980/81, $360 million in 1981/82, and $374 million in 1982/83 — the importance of non-resident investment in contributing to total business tax revenues is clear. In 1983, for example, 39 percent of the total of profits and dividend withholding tax came from overseas companies.

In addition, in 1984, 35 percent of the total assets of companies in New Zealand was held by overseas companies. These companies obtained 18.8 percent of their funds in that year from overseas loans — more than four times the ratio for listed New Zealand companies — although intercompany debt in 1980-83 accounted for only 7.6 percent of new investment in that period (compared to much higher proportions in earlier years). Although most new direct investment continued to come from Australia, Britain, and North America, Australia had become by far the most important single source of new investment in the 1980s, replacing the UK.

Two things are thus clear about foreign investment in New Zealand:

1. it contributes an important share of total tax collections from business income — as much as 40 percent in some recent years;
2. the major way these revenues are collected is through the company profits tax, with minor support from the non-resident withholding tax.

A final point which perhaps deserves emphasis is that these tax revenues constitute the one indisputably clear gain New Zealand obtains from the presence of such foreign investment. Many other advantages and disadvantages have of course been attributed to capital inflows in the literature, but there is virtual unanimity in the view that tax revenue is the best single proxy for national gains[2]. The maintenance of these revenues must therefore be an important concern of tax policy.

The Company Tax Rate

Consider first the corporate profits tax. A principal reason for maintaining an absolute corporate tax in an open economy is precisely to enable New Zealand to exert its claim to a 'fair share' of the returns to foreign investment. The announced intention to lower the existing tax from 48 to, say, 36 percent may make sense from the point of view of remaining competitive for new investment from countries such as the US and the UK which have recently similarly lowered their tax rates. On the other hand, such a reduction (with an unchanged base) would clearly reduce New Zealand's gains not only from new investment but also from the large stock of existing foreign investment. The responsiveness of new investment to tax rate changes would have to be improbably high to make this a winning strategy, at least in strictly revenue terms.

One answer might be to lower the tax rate on corporate investment only for resident shareholders (which is in effect what imputation does), but this does nothing to offset the reduction in New Zealand's attractiveness to new foreign investment as a result of its relatively high rate. Moreover, this approach gives rise to other problems

with respect to international capital flows, as noted below. Another answer might be to lower the company tax rate but to raise the dividend withholding rate on non-residents to maintain the revenue contribution of foreign firms. The problem with this strategy is that impossibly high withholding rates would be required, which would themselves act as a considerable deterrent to investment and would moreover accentuate greatly the existing pressures on multinational firms to minimise their New Zealand tax burden by financial restructuring.

There is thus no obvious solution to the apparent policy dilemma facing corporate taxation in economies which have substantial foreign investment in place and which wish to remain competitive with respect of new investment. Indeed, matters are even more complex than suggested above, since it is presumably effective rather than nominal tax rates that are most relevant. While no study of effective tax rates has apparently been carried out in New Zealand, studies elsewhere indicate that such rates are likely to vary widely over time and different industries, particularly in periods of high inflation such as New Zealand is now experiencing. The statutory rate is thus a poor guide to reality: nevertheless, the point that New Zealand's nominal rate is increasingly out of line with those of some of its major trading partners is relevant to the extent that prospective new investors are more likely to be deterred by the height of the nominal rate than enticed by the ease of avoiding it.

An additional complication in New Zealand is the linkage of the corporate rate with the top marginal personal rate, partly, it appears, to facilitate imputation and partly to reduce opportunities to avoid personal income tax. The rigid linking of what are two quite separate policy instruments in this way makes little sense. The appropriate rate of tax on foreign investment need bear no relation at all to the appropriate top personal rate on New Zealand residents. Even so far as resident investors are concerned, a spread of, say, 10 percentage points either way seems quite tolerable in principle and probably in practice.

Imputation

The introduction of the proposed full imputation system will exacerbate the problem in a number of ways[3]. In particular, the net effect of the new imputation system may in fact be to reduce the total benefits New Zealanders receive from investment in New Zealand, largely by reducing foreign investment in New Zealand (and hence New Zealand's tax share of such investment) more than it will raise investment in New Zealand by New Zealand residents. Imputation really amounts to a tax cut on certain capital income received by domestic shareholders. Its immediate effect is thus to transfer money to these shareholders. In the longer run, they may therefore increase their holdings of local assets. At the same time, however, because existing foreign investors on the whole lose out in relative terms, total investment may decline as they choose to invest less in the country[4]. This result seems especially likely with respect to foreign portfolio investment, as companies which have both domestic and foreign shareholders may well reduce cash dividends under an imputation system. Their

domestic shareholders will receive imputation credits but their foreign shareholders will not be so compensated.

Of course, some of the principal arguments for imputation concern its international aspects. For example, it may be argued that New Zealand is compelled to follow the model of its main trading partners in this as in other aspects of tax design. If they lower taxes on corporate-source income by adopting a dividend relief system, so must New Zealand if it is not to lose its 'competitive position'. Little weight should be attached to this argument, however. If New Zealand were really concerned with improving its 'competitive position', it would hardly be raising its corporate tax rate from 45 percent to 48 percent at a time when the US is lowering its rate from 46 percent to 34 percent, and Japan from 52 to 40 percent. The UK has already lowered its rate to about the US level, and countries as diverse as Canada and Singapore are making similar moves.

Setting aside the 'competition' argument, however, once it has been decided for whatever reason to provide some dividend relief to shareholders, most countries have adopted imputation as the preferred form of dividend relief precisely on international grounds. In particular, most countries have wished to deny relief both to non-resident investors (through denial of the imputation credit) and to their own residents who invest abroad (through a compensatory tax, or qualified dividend accounts, for instance). One question is thus whether the extent to which imputation lends itself to such discriminatory treatment constitutes much of an argument in its favour in terms of either efficiency or inter-country equity.

Imputation and International Efficiency

Suppose that a country with an imputation system wants, for some reason, to ensure that its capital is allocated as efficiently as possible from a world-wide point of view. What must it do? First, with respect to direct foreign investment by its residents, whether in branch or subsidiary form, it should

1. subject the returns from such investment to taxation on a current basis,
2. provide a full direct and indirect credit for foreign corporation and withholding taxes,
3. provide a full imputation credit on such distributions,
4. levy no additional tax on any subsequent distribution of the profits to residents, and
5. levy a special tax to recoup any imputation credits extended by the foreign country[5].

Exactly the same treatment is required for corporate and individual portfolio investors; again, in effect the foreign corporate tax has to be integrated with the domestic personal income tax, which means no compensating tax should be levied on dividends paid out of foreign-source income and such dividends should receive full imputation credits.

Note, however, that in this scenario there is no need for the imputation country to extend imputation credits to either portfolio or direct non-resident investors. Indeed, if it does do so, then the capital-exporting country in its turn must levy a special tax

to recoup the credit; otherwise, foreign investment will be inefficiently encouraged to the extent that net yields on foreign shares are increased by the dividend credit.

In practice, *none* of the conditions set out above is fully satisfied in any country. Except in unusual circumstances — such as branch operations or controlled subsidiaries in tax haven countries — foreign-source income is not generally taxed on an 'as earned' basis, but only when repatriated. Nor, to avoid opening the doors of the national treasury to foreign tax collectors, is a full credit (including refunds, if necessary) given in any country for foreign taxes. The indirect credit for foreign corporation taxes, for example, is nowhere extended to portfolio investors. Moreover, no country really provides full imputation credits on distributions out of foreign-source income (although Canada comes close). Indeed, many countries specifically levy compensatory taxes to ensure that this does not occur. And, finally, no one has ever suggested that a special tax should be levied by capital-exporting countries to recoup any dividend credits extended to non-residents by foreign countries; indeed, the usual argument made by capital exporters is that such credits *should* be extended!

Imputation and National Welfare

In short, there is no meaningful sense in which the imputation systems now existing in the world may be considered to result in the efficient allocation of capital from a world view. Substantial, and probably impracticable, revision would be required to achieve this goal. But why should any country be interested in making such revisions? Surely, as suggested earlier, a more appropriate aim for national tax policy is to maximise national, not world, welfare. Suppose, then, that the objective of a country with an imputation system is to maximise its *national* economic well-being. What must it do?

First, as noted earlier, such a country would not have a foreign tax credit system at all. Instead, it would permit only the deduction of foreign taxes, thus equating the net after-foreign-tax rate of return on foreign investment with the gross return on domestic investment. Foreign-source income would, in addition, have to be taxed on a current basis, since deferral undesirably encourages foreign investment. Since there is now no need to equate *total* tax burdens, however, the problem of integrating foreign corporation taxes with domestic personal income taxes no longer arises — although it is still necessary to provide full imputation credits to distributions out of foreign-source income, if foreign investment is not to be unduly penalised[6]. The appropriate treatment of portfolio investment remains complicated in that net dividends (including any dividend credit received from the foreign country) should be subject to domestic corporate tax, but full imputation credit should be given on portfolio dividends. Once again, no country is fully consistent in these respects. Both the exemption and credit (with deferral) systems favour investment abroad too much from this point of view.

Moreover, there is again no case for extending credits on investment by non-residents. In particular, such credits should not be granted for direct investment: almost by definition such investment must give rise to 'rents', or it would not be made,

and taxes on economic rents are, by definition, allocatively efficient since they will not affect investment[7]. The case for extending credits to portfolio investment is also weak, since the greater the responsiveness of such investment to tax differentials, the greater the revenue loss — and, since foreign portfolio investment (much more clearly than direct investment) is clearly a replacement for domestic investment, the tax take is the major national benefit received from such investment.

Imputation and Inter-Country Equity

No coherent efficiency rationale thus appears to explain the imputation systems found in most countries. Perhaps, then, the explanation lies rather in considerations of inter-country sharing of the gains accruing from foreign investment. From this point of view, however, the analysis is similar to that of national efficiency: what matters is how much a country gets to keep. As a capital importer, New Zealand should obviously levy as high taxes (corporate and withholding) on foreign investment as it possibly can. Assuming that taxes in other countries are independent of what it does, this means that portfolio investors are taxed at least up to the effective level of taxes in their home country, and that direct investors are taxed perhaps a bit in excess of this level (owing to the 'rent' factor almost invariably present with such investment). On the other hand, it can be argued that New Zealand as a capital exporter should levy taxes on its foreign investors in accordance with the 'national efficiency' criterion, that is, permitting only the deduction of foreign taxes.

How does imputation affect the division of the income from foreign investment between the home and the host country? A major role of company income tax from the point of view of host countries, as noted above, is precisely to assert their claim to the lion's share of the total taxes levied on this income. Perhaps the best of all strategies from the point of view of a capital-importing country would be not to adopt an imputation system at all but rather to have a relatively low corporate tax rate with high withholding taxes on payments abroad, and the total just equal to the rate in the capital-exporting country (assuming, of course, that that country has a credit-with-deferral system). In reality, as noted earlier, this strategy may not be open to New Zealand. Moreover, even in principle, to develop an optimal strategy for the taxation of foreign investment would be a much more complex task than this, requiring consideration of the relative 'size' (in terms of market influence) of the host country, the precise tax system of the home country, the importance of such constraints as the non-discrimination rule (and the elasticity of supply of domestic savings), and the importance of 'rents', etc. Presumably the 'best' tax would differ for each potential capital-exporter in principle; but in practice it would almost certainly have to be uniform for all, thus further constraining the freedom of national tax authorities. Despite all these qualifications, however, it seems clear that New Zealand should probably not follow Australia's chosen path of

1. imputation,
2. a high corporate tax, and

3. the abolition of dividend withholding taxes (in the probably forlorn hope of reducing the pressure to extend imputation credits to non-residents).

Non-Resident Withholding Taxes

The only aspect of New Zealand's present system of taxing foreign investment which seems to have occasioned much policy concern in recent years is the non-resident withholding tax on interest. Two sorts of criticism have been levelled at this tax:

1. It has been characterised as ineffective but troublesome, in the sense that while it can be avoided fairly easily, it is a nuisance to have to go through the necessary legal manoeuvres and to pay the small fee exacted by accommodating financial institutions.
2. It has been argued that — apart from some exceptional circumstances in which the foreign tax crediting system of the lending country in effect shifts the tax onto the obliging taxpayers of that country — the burden of taxes on international interest flows inevitably rests on immobile factors in small countries. If New Zealand levies a tax on interest when the world capital market in effect sets the rate of interest the only result will be to raise the gross return required by foreign lenders, thus raising the cost of capital in New Zealand and reducing the level of investment and hence real wages.

Both these arguments are substantially correct: that is, New Zealand cannot tax international interest flows very effectively, and it probably should not attempt to do so in any case. The answer, therefore, seems clear: abolish the tax, or, at the very least, create exemptions for long-term legitimate (non-related) corporate borrowing of the sort found, for example, in Canada or Australia. New Zealand too exempted loans for approved projects from 1975 to 1983.

The recent sharp rise in interest rates no doubt accounts for at least part of the steep rise in non-resident withholding tax collections to $87 million in 1986. Nevertheless, the possibility of exemption under certain circumstances should again be examined closely if it is desired that New Zealand investors should have free access to world capital markets at competitive rates. However, great caution is necessary because of the ease with which transactions between related parties can be disguised by interpolating one, two, or more friendly financial intermediaries. Under no circumstances should the non-resident withholding tax on interest be completely abolished.

The principal reason for this conclusion lies in the cliché that 'money is fungible'. If, as argued earlier, it is important to maintain withholding taxes on dividends paid abroad — and perhaps even to raise them, if the company tax rate is lowered — then it is essential to maintain taxes at similar rates on *all* forms of payments abroad in order to avoid opening the door of the treasury to multinational firms which can easily restructure the balance sheets of subsidiaries as tax minimisation requires.

To some extent, such manipulation can perhaps be checked, though not halted, by the adoption of statutory restrictions on so-called 'thin capitalisation'. A simple rule that the debt-equity ratio cannot exceed 3:1, or even 1:1, can of course be circum-

vented by only slightly more complex financial manouevres[8]. Nevertheless, such a rule serves two useful purposes:

1. it signals the clear concern of the authorities with this problem and establishes a 'bright line' test of what is not acceptable, and
2. it raises the costs of dodging the law at least slightly and hence may deter some marginal tax avoidance. The gain from such a rule may not be large, but since the cost is low there seems to be on the whole a strong case for the introduction of such a rule in New Zealand.

A variant recently employed in Norway[9] may also be worth exploration, namely, simply to assume for tax purposes that the debt-equity ratio for subsidiaries of multinational firms is the same as that of national firms in the same industry. This approach has the advantage both of recognising the different characteristics of different industries and of, so to speak, putting national and foreign firms on a more equitably competitive basis. On the other hand, it is a complex approach which is perhaps not usable in some sectors, and it can also be circumvented in various ways.

No matter what is done to block the more blatant avoidance techniques, however, it seems likely that it will still be essential to maintain a fairly uniform withholding tax on all forms of payments abroad in order to maintain a minimal degree of integrity in the income tax as a whole. In the case of interest, the arguments noted above against heavy taxes have gained force in the face of recent moves in both the US[10] and the UK[11], which make it less likely that high withholding taxes can be creditable in those countries. Nevertheless, the present 10 percent (treaty) rate at least should be maintained both to protect the revenue from international tax avoidance and also to make it more acceptable at some stage to extend similar withholding to domestic interest payments also, permitting such withholding taxes to be creditable for income tax purposes. As noted below, the mismatching of interest deductions and income flows is a bad enough problem in the international context without exacerbating matters by allowing a large fraction of domestic interest income to escape tax also.

The Taxation of Capital Outflows

Important though the points mentioned above are in the New Zealand context, undoubtedly the major immediate international tax policy issues concern the other side of the coin, namely, the appropriate tax treatment of capital outflows or, to put it more accurately, foreign-source income. The basic framework of the analysis was set out extensively in Chapter 2 above. The present discussion therefore focuses on what appear to be the three areas requiring action — or, in one instance, non-action — in the immediate future:

1. the foreign tax credit,
2. tax havens, and
3. allocation rules.

Although the area requiring most immediate action is tax havens and in a sense the most important questions arise with respect to allocation, it is useful to begin with a brief discussion of the foreign tax credit.

1. The Foreign Tax Credit

At the present time, as noted in Chapter 3, New Zealand has a direct foreign tax credit coupled with an exemption of dividends received from abroad by New Zealand resident companies. The impending introduction of an imputation system means that this system has to be reconsidered carefully, since unless the matter is thought through in advance, pressures to expand the scope of the present system may be too readily accepted. In particular, New Zealand should definitely avoid following the Australian lead of adopting what is perhaps the world's most generous indirect foreign tax credit, extending through infinite tiers with an overall limitation[12]. Instead, it should in principle follow as closely as possible the path sketched by Benge and Robinson[13], namely, to subject foreign-source dividends to tax but to allow at most only a direct credit. The argument for this position in terms of removing undue favouritism to foreign investment, in terms of revenue, and in terms of curbing international avenues of tax avoidance, is overwhelming in principle.

In contrast, as argued in Chapter 2, the conventional efficiency and equity case for the conventional foreign tax credit, with deferral, is not particularly convincing[14]. In practice, three conclusions may be reached with respect to foreign tax credit systems as they actually operate in any country:

1. they are exceedingly complex;
2. they yield little revenue; and
3. they do not achieve capital-export neutrality.

The evidence for the first two of these statements is plain to see in all countries that have such systems. One reason for both the complexity of the system and their small revenue yield is precisely because they do not achieve capital-export neutrality, mainly because they operate only when funds are repatriated. Since earnings retained abroad are thus in effect exempt from domestic taxes, so far as the 'mature' foreign investment which is most important in New Zealand is concerned (that is, where investment is financed out of retained earnings or foreign borrowing), there is little or no difference in practice between an exemption system and a credit-with-deferral system[15]. *Both* systems favour investment abroad, particularly in low-tax rate countries, relative to investment at home, and both therefore make little sense even from the international efficiency viewpoint underlying the usual case for a foreign tax credit.

Moreover, the foreign tax credit system as it usually operates is not neutral as regards portfolio and direct investment since the 'indirect credit' clearly favours the latter. Again, the efficiency implication of such favoritism is far from clear — as are the costs of complicating New Zealand law by introducing such a distinction.

Finally, in practice the foreign tax credit invariably fails to achieve capital-export neutrality through various limiting factors such as limitations by country or type of income, limited or no carryovers, and reduced creditability of certain foreign taxes. Such limits, however, unlike deferral, may to some extent be justified as reducing the incentive to invest abroad beyond the point at which foreign income (net of foreign

tax) just equals domestic income (gross of domestic tax), thus fostering 'national' as opposed to 'international' efficiency.

Foreign Tax Credits in International Context

Even the usual deficient foreign tax credit when viewed as a replacement for exemption — for which nothing good can be said in principle — is clearly an improvement. The main problem with the credit is simply that it is not nearly as good from a national perspective as a system of current taxation of foreign-source income with deduction for foreign taxes would be. The main advantage of the credit is that it is internationally respectable and hence presumably more acceptable — and less vulnerable to retaliation — than a deduction system would be. If the credit is thus viewed as a compromise between the exemption and the deduction, the more limited the credit is, and the better off New Zealand (if not all New Zealand firms) will be. Limits on the credit not only by country but also by source of income, as well as allowing no carryover, may thus all be quite acceptable moves in terms of both national efficiency and inter-country sharing of the gains from foreign investment, although clearly bad from the point of view of 'world efficiency'.

Of course, should foreign countries retaliate as a result of New Zealand moves in this or any other international tax arena and squeeze their own foreign investors harder, with the result that foreign investment in New Zealand declines, then New Zealand, where capital imports are still much more important than capital exports, would lose. The rules of the international tax game were not set up for 'policy-taking' countries like New Zealand. Unless such countries play by the rules, however, even at the expense of forgoing some advantages (for example, through allowing only the deduction of foreign taxes), they may well lose. In a world of 'dog eat dog', it is the smaller dogs that are most at peril. It is therefore countries such as New Zealand that may have the most to gain from fostering international tax co-operation, even if the price of doing so may sometimes be such fundamentally inappropriate and irrational gestures as extending imputation credits to foreign investors from countries without comparable imputation systems or giving its own investors more credit for foreign taxes than is really in the national interest.

The motto of countries like New Zealand, which in part adopt the credit approach for reasons of international comity, ought perhaps to be "A foreign tax credit if necessary, but not necessarily a foreign tax credit". That is, adopting the form of the credit may make sense as a matter of international political economy, but its actual operation should, in the national interest, be as restrictive as possible, as well as backed up by some tax haven legislation with teeth. The latter will obviously complicate matters at least as much, if not more, than the credit: but unlike the credit, tax haven legislation will clearly be in the national interest — and may even yield some revenue.

2. Tax Haven Legislation

Indeed, the international tax measure most urgently required in New Zealand is undoubtedly some form of tax haven legislation. The basic problem giving rise to this

need is the failure to tax foreign-source income on the same basis as domestic-source income. Even if, as suggested above, foreign-source dividends were taxed, this problem would remain since it arises from the deferral of tax on foreign-source income until it is repatriated. Indeed, taxing incoming dividends would exacerbate the problem by increasing the value of deferment relative to repatriation. Of course, a case can be made — basically on 'competitive' grounds — for the deferment of taxes on genuine foreign-source income. Although not convincing in economic terms, such arguments have clearly been persuasive to governments all around the world. New Zealand seems unlikely to prove an exception.

The trouble is that, once one creates a legitimate source of tax-free (or at least tax-deferred) income, the temptation to convert other forms of income into the favoured form becomes too great for many taxpayers to resist. It is this problem which makes the distinction between tax-preferred capital gains and taxable income the bane of the effective taxation of income in so many countries (including New Zealand). It is the same problem which lies at the root of the international tax avoidance industry. If deferral is accepted as a necessary evil for legitimate foreign investment activities, then a wall must be erected to separate those activities ('good deferral') from illegitimate attempts to convert what is really New Zealand source income into what looks like foreign-source income ('bad deferral').

Such a wall has now been erected, with varying degrees of success in quelling attempts to convert domestic-source into foreign-source income, in at least six major capital-exporting countries: the United States, the United Kingdom, Japan, West Germany, France and Canada[16]. Australia and New Zealand seem destined to join this select group within the next year or two. Four things can be said about the legislation now in place in these countries:

1. it is likely to constitute one of the more complex parts of tax law;
2. it is unlikely to yield much, if any, revenue in its own right;
3. it is impossible to make such legislation fully effective; but
4. such legislation nonetheless constitutes an indispensible part of any would-be comprehensive income tax strategy in a country with significant capital exports.

Tax haven legislation will be complex because the reality with which it must deal is itself complex. Moreover, given the relative ease with which skilled tax practitioners can devise new avoidance schemes, it is likely that the limits of any legislation intended to block tax haven activities will be constantly tested, thus requiring continuous attention, adjustment and modification. Mere surface complexity, however, is no reason not to proceed immediately with at least some form of legislation to deal with the more obvious tax haven possibilities, perhaps along the lines of the UK legislation on controlled foreign corporations, and perhaps incorporating some aspects of Canada's FAPI (foreign accrual property income) legislation along the lines spelled out in detail by Arnold[17].

Whatever form tax haven legislation takes, however, it is unlikely to yield much revenue directly. Canadian practitioners, for example, tend to hang their heads in shame if any of their clients are actually subject to tax on FAPI. The point, however,

is that this legislation is nonetheless needed to ensure that taxes are collected elsewhere in the tax system by blocking certain easy and blatant forms of avoidance. Clever and determined taxpayers can, of course, still maneouver around the boundaries of tax haven legislation, but only at a cost. As in the case of thin capitalisation rules, appropriately designed tax haven legislation both deters some avoidance by raising the costs and also makes it much clearer where the law draws the line between avoidance and evasion. Despite the apparent costs imposed on taxpayers and the administration alike by the addition of some complicated new sections to the income tax act, the long-run effects of increased certainty about the applicability of rules to transactions and the protection of revenue from certain flagrant forms of abusive tax shelters seem, on balance, well worthwhile.

3. The Role of Allocative Rules

Perhaps the single most important measure needed in New Zealand to cope with the problems created for the tax system by the openness of the economy, however, is to establish a set of specific guidelines governing the allocation of expenses, and perhaps even income, between New Zealand and foreign sources. Like the thin capitalisation and tax haven rules mentioned above, rules determining the allocation of expenses for interest, royalties, management fees, head office costs, research and development and so on are likely to be complex, arbitrary, and probably subject to constant pressure and perhaps adjustment. They can also often be circumvented by determined taxpayers, albeit usually at higher costs than in their absence.

Nevertheless, as with thin capitalisation and tax haven legislation, such rules are needed to provide more certain guidance to taxpayers and administration alike: to set up 'bright lines' dividing the acceptable from the unacceptable, together with some 'safe harbours' to accommodate cases straddling the line. Moreover, even in the absence of avoidance pressure, such rules are needed to determine what is 'really' net foreign-source income. That is, unlike most of the other features of the tax system discussed to this point, allocative rules not only guard against avoidance but go to the heart of the entire income tax system in the sense that, when appropriately structured, they determine what share of the income of multi-national enterprises, whether New Zealand or foreign-based, falls within the scope of the New Zealand tax system.

The Separate Entity Arm's Length Approach

This statement may seem unduly strong to those familiar with the existing world of international income taxation sketched in Chapter 2 above. That world is structured on the premise that the different components of international firms should be recognised as separate entities, with intercompany transactions being assessed for tax purposes on a transactional basis as though they took place at arms' length[18]. The deferral privilege extended to offshore subsidiaries and the prevalence of rules aimed at enforcing 'correct' pricing (for example, Section 22 in New Zealand, Division 13 in Australia, and Section 482 in the United States) essentially reflects these underlying assumptions.

Unfortunately, there are two serious problems with this approach:

1. it does not work well because it is exceedingly difficult to apply in the way the law tends to presume; and, more importantly,
2. this approach will never work well because it rests on a fundamental misunderstanding of the reality of international business.

The following discussion elaborates briefly on both of these points and makes some suggestions for solutions to the problems inherent in them. It should be emphasised, however, that this important area of international tax policy has not, as yet, received the careful and detailed scrutiny it requires in any country. To some extent this discussion thus represents more a call for more light to be cast on these issues than the shedding of such light itself. Moreover, when carried to the logical extreme of applying an allocative formula not merely to certain expense items but to the combined worldwide income of multinational businesses, not only is this 'unitary' approach relatively unexplored, but also it has unfortunately been unjustly criticised and attacked by many in recent years owing to its partial application by some states of the United States[19]. A small country like New Zealand must therefore proceed very cautiously in such unchartered and unpopular waters as unitary taxation. Nevertheless, the case for doing so in general is so strong[20], and the need to do so with respect to particular expense items so great[21], that this area should remain high on both the immediate and the long-run research agenda of those concerned with the taxation of international income in particular, income from capital in general, or indeed the future of the income tax at all.

Allocating Expense Deductions

The most immediate problem is to devise appropriate means of deciding what proportion of expenses incurred to earn income is properly attributable to (presumably taxed) domestic-source income and what proportion to (generally tax-deferred) foreign-source income. Consider interest expenses, for example. Recently, New Zealand has taken important and much needed steps to bring the intertemporal allocation of interest deductions and the income to which they give rise into balance[22]. While such measures will inevitably remain imperfect so long as there are important untaxed forms of income such as capital gains and untaxed entities such as superannuation funds, the new rules on the accrual of expenses and income (including foreign currency gains and losses) clearly mark a substantial improvement in the fairness, efficiency, and integrity of New Zealand's income tax. Exactly the same problem of the mismatching of income and expenses can occur interjurisdictionally as well as intertemporally: tax on domestic-source income may be eliminated by borrowing which gives rise to foreign-source income which is not taxed currently or, in some instances, at all.

The only way to deal with this sort of problem is essentially the way that intertemporal mismatching has been dealt with, that is, by drawing up as clear and complete a set of rules as possible with the intent of allowing deductions only when taxable income is generated[23]. Strictly speaking, in the case of borrowing for overseas

activities, what is required is the capitalisation of interest expenses, with amortisation being allowed only against repatriated foreign-source income. Such treatment would probably be considered much too harsh on competitive grounds, however. Moreover, so long as other countries continue to allow full current interest deductibility, New Zealand-based firms would not only be disadvantaged in their overseas activities but also vulnerable to takeover bids from abroad.

Similar objections may be made to the rule of simply disallowing interest deductions for offshore activities — a rule which in any case can usually be subverted fairly easily by appropriately structuring financial transactions. Indeed, it is difficult to think of any way of segregating or quarantining 'foreign' interest deductions from the general interest deductibility problem.

The pure 'tracing' system apparently required by New Zealand jurisprudence, like the simple disallowance of deductibility for loans financing certain activities, is a non-starter in practical terms. A 'pro-rata' allocation like that described earlier with respect to the thin capitalisation problem in Norway or as used in the United States and Japan (based on the book values of foreign and domestic assets) is clearly more practical, but its results in many instances may be so harsh, or so at variance with perceived realities, as to be unacceptable.

In themselves, of course, such outcomes by no means constitute an insuperable argument against such practices: given the alternative of doing nothing — which really means taxpayers can do more or less what they want — a little arbitrariness may not be too high a price to pay. In all likelihood, however, such rules realistically will have to be designed to favour taxpayers, at least to some extent. Another possible approach might be to continue to rely on tracing, but to buttress it with a statutory presumption that interest expenses are first applied to generate taxable income and then non-taxable income. The effect would be to disallow deductions in excess of currently assessable income, thus at least avoiding the creation of some of the tax loss 'hangovers' engendered by the current rules.

Problems with the Present Approach

The approach to the expense allocation problem implicitly embodied in existing laws and treaties is usually assumed to start from the separate entity arm's length basis described above. In essence, it amounts to imputing to intercompany loans an interest rate supposedly equivalent to the 'market rate' on a similar transaction. There are at least three problems with this approach, however:

1. At best it simply denies deductibility to 'excess' interest expenses; it does nothing to deal with the fundamental mismatching problem.
2. Like all transfer pricing approaches, particularly those related to the transfer of intangibles[24], it is extremely difficult to employ in practice given the myriad of conceivably applicable rates. Either an arbitrary rate (the average government borrowing rate or whatever) is employed, or the determination of the rate becomes one more element in the discretionary bargaining between taxpayer and tax

administrator which in the end so often determines the final tax liability with respect to international income flows.

3. The entire attempt to determine the appropriate 'arm's length' rate is in any case fundamentally flawed. In an important sense, the essence of a firm operating across international borders is that it operates as a sort of internal capital market obtaining the lowest cost of capital for the firm as a whole. Any attempt to segregate that cost among the legally separate components of the firm in accordance with the way the transactions happen to be recorded in the accounting records of the various subsidiaries is thus meaningless, whatever analogies may be tortuously made to 'market' transactions.

The Need for a New Approach

In short, while there is no clear, simple way in either principle or practice to deal with the problems arising from the jurisdictional mismatching of interest or other expenses, on the whole it seems best to set out as clear guidelines as possible in the form of a reasonable rule and then to stick to it as consistently as possible, for example dealing with variants and difficult cases as they come up through a (published) ruling system. The fact is that in almost all cases where a statutory basis is provided for allocating an expense item, the rule is based on some sort of formula apportionment for the reasons given above: no other solution is really possible, and a clear basis must be provided to resolve conflicts.

The obvious willingness of financial intermediaries to interpose their serried ranks between the component parts of the same company means that such rules cannot and should not be restricted solely to related-company transactions, as is the case with most transfer-pricing approaches. The rules should therefore be of general applicability. They will probably also, as is usual in the international arena, be complex in appearance, and in practice catch mainly the ill-advised. Nonetheless, despite their obvious imperfections and arbitrariness, such allocative rules seem clearly preferable to the alternatives of either no rules or the impractical discretion of the pure arm's length approach. As with most of the other devices mentioned above, good rules will provide some needed guidance to both honest taxpayers and the overworked administration, while raising the costs of tax dodging for the unscrupulous. Little more can be asked of any tax provisions in the complex international environment in which small countries like New Zealand must live.

Given the greater jurisdictional span of enterprises than of countries, it may even be considered appropriate to load the allocative rules a little against taxpayers. Countering the tax-minimising discretion of taxpayers in the international arena simply by giving similar discretion to administrators to pierce the veil of legal form and look through to the underlying economic reality does not seem advisable, however. General anti-avoidance provisions such as Section 99 may be needed as an ultimate deterrent to avoidance but, like atomic weapons, such big threats are most useful if they are not used. It is always better to incorporate specific anti-avoidance rules whenever a problem area emerges in order to provide as much certainty as

possible, thus reducing risk, lowering investment costs, and presumably improving the well-being of the nation. The resulting apparent complexity of the tax law is a small price to pay. In any case, legal complexity simply mirrors the complexity of the real world of international business with which the law has to cope.

What has been proposed to this point is the careful development and structuring of a set of specific guideline rules with respect to the allocation of deductible expenses between domestic and foreign source income. A few illustrations of the sorts of rules that might be applied to the important case of interest have been mentioned. Similar, variant rules might be considered with respect to other expenses such as research and development on head office expenses — for example, in proportion to gross receipts — along the lines set out in the US Internal Revenue Code's Section 861 (and recently emulated in Japan), if not necessarily in the same form or level of detail. The underlying promise of this approach is that, as the father of the modern arm's length approach presciently hinted a decade ago[25], the arm's length approach to these problems has been tried and found wanting, so what is now needed is more careful and conscientious consideration of various formula approaches. New Zealand, which comes fresh to this area, has a unique opportunity to start out with a consistent set of such formula allocation rules rather than, as has been the case in countries such as the US, in effect being driven to them in a haphazard fashion by the inoperability of the arm's length approach.

Allocating Income by Formula

Once all or most deductions are allocated by formula, of course, it is but a short step to allocating income itself by formula[26]. The basic reality is that there is, even in principle, no clear, objective economic basis on which to allocate revenues and costs to the particular units that comprise parts of a multijurisdictional enterprise. Almost by definition, the operation of multinational firms involves what economists call 'joint products' and 'nonmarketed intermediate goods', that is, activities involving costs which typically cannot be allocated with certainty to the various branches, divisions, affiliates or subsidiaries of a firm. Technology and management services, for instance, are intangible factors that may be applied to one division of a firm without detracting from their value elsewhere. Similarly, the financial costs incurred by closely-related businesses cannot easily be assigned as costs to particular units or divisions. Such problems are particularly important with respect to multinational firms. Indeed, in the absence of such 'intangible assets' that can be exploited by multinational enterprises, it would be hard to understand their existence at all, let alone their dominance in important fields, since foreigners are inherently at a disadvantage compared to local firms unless they have some offsetting internal advantages as a result of being under common control.

The very essence of a multinational enterprise in a sense is thus its ability to achieve higher revenues (or lower costs) from its different subsidiaries *as a whole* compared to the results that would be achieved under separate management on an arm's length basis. The allocation of profits within a multinational enterprise is thus

inherently and unavoidably arbitrary since such businesses are, as a rule, inevitably 'unitary' in character. In addition, as noted above, the reported interjurisdictional allocation of costs and revenues must be expected to push against the constraints imposed on global profit maximisation by national tax policies.

The unitary approach to assessing the income of firms operating internationally thus has in its favour the economic reality that the income of a multinational enterprise is the fungible product of a set of integrated income-producing factors that are essentially under one control, regardless of location. The apportionment of this tax base among jurisdictions, once it has been determined, is, under this approach, based in some fashion on the geographic distribution of property and activities that are presumed to contribute to the integrated income-producing process. Because it relies on direct measures of the share of the selected income-producing factors that are located in the taxing jurisdiction, which can, as a rule, be quantified on a relatively objective basis, this formula apportionment approach avoids the detailed inquiry into particular transactions that characterises 'arm's length' separate accounting. It also obviously curtails the freedom of firms to move accounting profits around to minimise taxes. The appeal of the unitary approach to tax administrators is obvious.

On the other hand, formula apportionment might introduce significant distortions in the division of the tax base, especially if the productivity of factors differs substantially among the various jurisdictions involved. Differences in wage scales and in property costs are often cited as examples of disparities that may cause apportionment formulae to be distortive. Moreover, greater accounting demands are put on multinational firms, especially with fluctuating exchange rates and different national accounting requirements, and, as just noted, their freedom to move profits around for tax minimisation is greatly curtailed. The distaste of many multinational businesses for the unitary approach is thus equally obvious.

The fact is, however, that for most multinational corporations separate accounting is conceptually wrong, since if it were not for unallocable intangible joint assets, multinationals would not exist. In addition, as every tax administrator and corporate tax planner knows, separate accounting provides leeway for global tax minimisation through often quite legitimate transfer pricing and cost allocation manoeuvering. Taxing jurisdictions therefore need a set of clear, enforceable rules to deal with the resulting difficulties.

The current international reliance on separate accounting itself requires a considerable amount of international co-operation and information if it is to work correctly — even neglecting the important fact that it simply cannot do so in the case of a truly unitary business. It is by no means clear that the additional compliance burden of the unitary approach, so often stressed by its opponents, would be all that excessive. If, for example, origin sales were to be used as the basis for international formula allocation, such data are not that hard to come by. Any such formula will of course always be arbitrary to some extent — but then so is separate accounting, for the reasons noted earlier.

Unitary taxation may indeed have some undesirable allocative effects, as economists have often stressed. In practice, however, taxes levied on a separate accounting basis may also have allocative effects which may be equally undesirable from some perspectives. Contrary to what economists sometimes conclude, however, this does not necessarily make either approach undesirable, since their major purpose is the distributive one of allocating tax base among jurisdictions in some reasonable relation to activities. In the international tax arena, where almost any conceivably practicable set of different national tax systems will inevitably produce some allocative distortions, allocative efficiency is in any case often a secondary issue. The choice of rules for allocating international tax bases to different jurisdictions will in practice generally continue to be determined more by concepts of 'fairness', and by the reality of differing degrees of national political and economic power vis-a-vis other nations and multinational firms, than by the concern for efficiency alone which is assumed in most economic analyses.

Taxing Multijurisdictional Firms

The most important conclusion to be derived from this preliminary discussion of a very complex issue is simply that no one as yet knows how best to deal with the inherent problems of taxing multijurisdictional firms. If it has served no other purpose, the recent debate on unitary taxation in the US has brought out the fragile and fundamentally unsatisfactory compromises that lie at the foundation of the present system of taxing international income. The veil of separate incorporation, the mysteries of multi-currency accounting, the shield of deferral — all these are pierced by the insight that, to paraphrase Gertrude Stein, in a real and fundamental sense "a business is a business is a business". The admitted difficulty of defining a 'unitary business' in precise terms does not in any way affect this truth. The question is, what can be done about it in practical terms?

The almost Pavlovian reaction of most tax professionals and multinational firms in defence of the accepted separate accounting approach is perhaps understandable. But it is also obviously unsatisfactory, as is suggested by the fact that no country appears to use this approach with respect to allocating income among separate internal jurisdictions[27]. Everyone may understand in some vague sense with respect to multijurisdictional enterprises within a country that it seems 'fair', for instance, to allocate some profit to the state in which the product is sold and some to that in which it is made. What the recent unitary debate in the international context has brought into sharp focus is that the implicit division of the international tax base arising under the present rules seems less likely to pass this basic test of fairness. One answer to this problem may well lie in the extension to the international sphere of some version of the unitary apportionment approach.

Such an approach for instance, might include

1. an agreed, simplified, broad definition of income,
2. an agreed concept of 'unitary business',

3. an agreed minimal jurisdictional requirement (such as the permanent establishment rule),
4. an agreed method of foreign currency translation, and
5. the creation of a method of dispute resolution.

As even a brief consideration of this list should indicate, any full solution to this problem is doubtless years away. Indeed, it seems unlikely that every country could ever be brought to agree on these matters in all respects.

Nevertheless, in the long run the development of international links between tax administrations — whether through bilateral or unilateral treaties, or a set of unilaterally-applied agreed principles, or even an international agency (Intertax?) — to match the links already existing among firms seems essential, unless the weaker countries are willing to continue to accept whatever largesse the conscience of the international firms operating within their boundaries chooses to bestow upon them in the form of taxes. Even within sophisticated countries such as Canada, Australia and New Zealand, tax officials have been increasingly troubled by their inability to obtain the full picture with respect to international transactions and their consequent feeling that, for some taxpayers at least, the extent to which they pay taxes has become largely a voluntary act. Perhaps the only answer to these difficult problems, however unsatisfactory it may be, lies in the sort of tortuous, endless negotiation that has in the past characterised such international debating forums as the Tokyo Round and the Law of the Sea.

Whatever the future may hold, the attitudes of countries such as New Zealand to this question should perhaps be shaped by their long-term interest in a stable, fair division of the international tax base, rather than solely by the perceived increased taxes that might be suffered by this or that locally-based multinational as a result of a particular change in the international rules of the fiscal game. In this, as in other areas, the interests of 'middle-level' countries seem likely to be best served by fostering co-operative, rather than confrontational, policies whenever possible, even at the expense of some short-run economic pain.

The degree of international agreement needed to attain much progress in the unitary direction may seem unrealistically great. But the alternatives for increasingly outflanked national tax administrations in this age of financial and technological international interdependence seem so bleak that something will have to be done some day. In the end what is done will likely contain a considerably larger component of the unitary, formula apportionment approach to the interjurisdictional allocation of income than the current state of professional thought appears to suggest.

Strategies for New Zealand

One strategy might be for New Zealand to go boldly where no country has gone before into the unchartered territory of unitary taxation. There are at least three problems with this approach, however:

1. Other countries would doubtless react strongly and adversely. This reaction could no doubt be tempered by a simultaneous substantial reduction in New Zealand's

corporate tax rate, but such a reduction would be costly in terms of giving up revenue from existing foreign investment. It is unlikely in any case that countries so recently on record as being strongly against California's unitary approach would refrain from attacking economically much less significant New Zealand on this account.

2. No one in any country has yet done the extensive homework needed to put in place a workable unitary system at the national level. Even if such a system could be devised (perhaps working from the California model) for New Zealand-based multinationals, it is not at all clear how it could be applied to foreign-based multinationals — or, for that matter, whether any New Zealand-based multinationals would long remain.
3. So long as New Zealand's explicit 'formula' is less advantageous to a significant number of firms than the implicit 'formulas' now more or less unconsciously applied through the separate entity rule in New Zealand and elsewhere, New Zealand is likely to lose tax base. The vocal protests of foreign governments acting on behalf of their interested firms are thus buttressed by the ease with which those firms can exit — or choose not to enter — countries in which they dislike the tax environment.

For these reasons, therefore, the most judicious approach for New Zealand to follow at the present time appears to be to concentrate on the immediate problem of developing workable rules for the interjurisdictional allocation of deductible expenses. The broader question of the interjurisdictional allocation of income must, it seems, be postponed until at least some of the bigger players in the international tax game see the light. New Zealand's interest should thus lead it, like other small countries, to bring up the formula allocation question at all conceivable international forums, but not to stick its own neck out too far by pioneering this radically different approach.

Notes to Chapter 4

1. The data discussed here were kindly made available by the Reserve Bank of New Zealand and the Inland Revenue Department.
2. David G Hartman (1985). 'The Welfare Effects of a Capital Income in an Open Economy', National Bureau of Economic Research Working Paper 1551.
3. The following argument is taken from Richard M Bird (1986a). 'International Aspects of Tax Reform in Australia', Unpublished paper, Australian Tax Research Foundation, Melbourne.
4. John Mutti and Harry Grubert (1985). 'The Taxation of Capital Income in an Open Economy: The Importance of Residence-Non-residence Tax Treatment', *Journal of Public Economics* 27, pp 291-309.
5. Mitsuo Sato and Richard M Bird (1975). 'International Aspects of the Taxation of Corporations and Shareholders', *IMF Staff Papers* 22 (July) pp 384-455.

6. The argument that the benefits of imputation should not be extended to dividends from foreign-source income in order to maximise national welfare (Matt Benge and Tim Robinson (1986). *How to Integrate Company and Shareholder Taxation,* Institute of Policy Studies, Wellington) does not hold if such income is taxed currently and only the deduction of foreign taxes is allowed, as assumed here. In the absence of this welfare-maximising treatment of foreign-source income, however, a good case can be made against allowing imputation credits on such income in order to avoid making a bad situation worse.
7. Richard M Bird (1986b). 'Interjurisdictional Allocation of Income', *Australia Tax Forum* 3, pp 333-354.
8. John Prebble, *Taxation of International Income,* Butterworths, Wellington, forthcoming.
9. Axel Haerem (1986). 'Net Wealth Tax and Capital Transfer Tax in Scandinavia', Unpublished paper, Australian Tax Research Foundation, Sydney.
10. See 'Chief Effects of Tax Act on Foreign Investors', *Financial Times World Tax Report*, October 1986, for details.
11. See 'Budget Britain', *The Economist*, March 21 1987, for details.
12. Robert Deutsch (1986). 'Foreign Tax Credits', Unpublished paper, Australian Tax Forum, Sherbrooke, Victoria.
13. See Benge and Robinson (1986). *op. cit.*
14. Portions of the following argument are taken from Richard M Bird (1986a). *op.cit.*
15. David G Hartman (1980). 'The Effects of Taxing Foreign Investment Income in an Open Economy', *Journal of Public Economics* 13, pp 213-230; and David G Hartman (1984). 'Tax Policy and Foreign Direct Investment in the United States', *National Tax Journal* 37, pp 475-487.
16. Brian J Arnold (1986). *The Taxation of Controlled Foreign Corporations: An International Comparison,* Canadian Tax Foundation, Toronto.
17. *Ibid.*
18. For example, this is codified in OECD (1977). *Model Double Tax Convention on Income and on Capital,* Paris.
19. Charles E McLure Jr (ed) (1984). *The State Corporation Income Tax: Issues in Worldwide Unitary Combination,* Hoover Institution Press, Palo Alto.
20. See, for example, Geoffrey J Harley (1981). *International Division of the Income Tax Base of Multinational Enterprise*, Multistate Tax Commission, Boulder, Colorado; and Richard M Bird and D J S Brean (1986). 'The Interjurisdictional Allocation of Income and the Unitary Taxation Debate', *Canadian Tax Journal* 34, pp 1377-1416.
21. Michael J McIntyre (1987). 'Allocation of Income among Related Parties', Unpublished paper, Wayne State University, Detroit.
22. *Consultative Document on Accrual Tax Treatment of Income and Expenditure,* October 1986; and *Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure*, Government Printer, Wellington, 1987.

23. Note that this discussion is not concerned with the well-known 'double dip' maneouver under which, in effect, the same act of borrowing gives rise to interest deductions in two different countries e.g. New Zealand and Australia. The concern here is with protecting New Zealand's revenue base; Australia (or wherever) is presumed to be able to look after its own problems.
24. Michael J McIntyre (1987). *op.cit.*
25. Stanley S Surrey (1978). 'Reflections on the Allocation of Income and Expenses among National Tax Jurisdictions', *Law and Policy in International Business* 10, pp 409-460.
26. The following paragraphs are largely taken from Richard M Bird (1986b). *op.cit.*
27. Richard M Bird and D J S Brean (1986). *op.cit.*

5 Conclusion

The convoluted, if condensed, argument of this paper may now be summed up in a few short propositions, as follows:

* The key immediate international tax problem facing New Zealand is to block the ease with which the taxation of domestic source income can be converted into foreign-source income.
* The principal weapon needed for this task is the immediate adoption of some form of tax haven legislation.
* Even more important, if less urgently needed, is a set of carefully drawn rules for allocating deductible expenses between domestic and foreign source income for all taxpayers, not just those engaged in tax haven operations.
* Over the long run, New Zealand should carefully consider both how to devise a workable unitary allocation and how to persuade the major capital-exporting nations of its suitability.
* Both tax haven legislation and effective allocative guidelines require more complete disclosure of transnational transactions. New Zealand should consider something more along the lines of the full-disclosure 'spreadsheet' proposed in the recent US proposal intended to replace the state unitary system[1] than the simple indication of activity required in Australia's new Schedule 25A[2].
* The international implications of imputation, of changes in corporate tax rates, of changes in the foreign tax credit, and of non-resident withholding taxes continue to need careful attention and monitoring. None of these issues can be considered independently of the others, of what is done in other countries, or of other aspects of the domestic tax system. On the whole, it appears that it may be wise to maintain present withholding taxes, to lower corporate taxes as little as possible, not to make the present foreign tax credit more generous, and probably to subject foreign-source dividends to tax.

The points listed above should be considered more an agenda for further research than a definitive set of recommendations for action. The task of the present paper has been to attempt to place the international dimension of tax reform in New Zealand in appropriate perspective and to suggest some areas which appear to call for action. Given the complexity of the international arena and the author's lack of detailed knowledge of the New Zealand tax system, it has not been possible to go further than attempting to set out some general guidelines for future work. If this paper succeeds

in alerting at least some people to the actual and potential importance of what is at stake in some of these apparently esoteric matters, let alone illuminating some possible solutions, it will have accomplished its intended purpose.

Notes to Chapter 5

1. See 'Chairman's Report on the Worldwide Unitary Taxation, Working Group: Activities, Issues, and Recommendations'(1984). *Tax Notes*, August 6, pp 597-98.
2. Australia, Commissioner of Taxation (2 July 1986). 'International Transactions. New Information Requirement for Companies', Press Release No 16.

Glossary

Arm's length pricing: A rule used to divide profits between firms located in different jurisdictions on the assumption that transactions between them are conducted entirely on a market-determined basis, regardless of any common ownership or other relationships between the firms.

Branch tax: A tax (equivalent to a withholding tax) levied on the profits of foreign branches in addition to the normal profits tax.

Branches: Foreign-owned firms that are not separately incorporated but operate as an integral part of the parent firm.

Capital-export neutrality: A condition in which taxes do not alter the decision of resident investors as to whether to invest at home or abroad.

Capital-import neutrality: A condition in which residents investing abroad are not discriminated against vis-a-vis other investors in the host country.

Credit method: see Foreign tax credit.

Deferral: The practice of subjecting returns from foreign investment to taxation ony when they are repatriated to the country of residence of the investor.

Direct investors: Foreign investors who are presumed to exert control over the activities of their foreign subsidiary or branch.

Economic rent, or quasi-rent: A return to investment in excess of the amount needed to induce the investor to make the investment.

Efficiency: A state which is achieved when productive resources cannot be redeployed in such a way to increase the well-being of the relevant population. (See also International and National Efficiency).

Excess burden or dead weight loss: The social cost of the lost output resulting from inefficiency in allocating economic resources as a result, for instance, of unneutral taxes.

Exemption method: Exempts from domestic tax the income derived by residents abroad.

Foreign tax credit: A provision that permits the offsetting of tax paid abroad against tax due domestically.

Formula allocation: A rule that attributes the deductions (or profits) of a multinational firm to its component parts in accordance with a formula based on such observable characteristics as sales, assets, or employment.

Fungibility of finance: This term signifies the ease with which one sort of financial transaction can be changed into another sort.

Harmonisation of economic policies: Commonly used as virtually equivalent to 'uniformity', at least when applied to policies in different countries.

Imputation: The offsetting of corporate-level taxes against personal income taxes due on dividend income.

Indirect tax credit: A foreign tax credit extended to include the underlying corporate taxes paid to foreign governments in addition to direct withholding taxes on dividends.

Informal or underground economy: That part of market economic activity that escapes taxes because it does not come to the attention of the authorities.

Inter-country equity: A concept relating to the manner in which tax revenue is shared between capital-importing and capital-exporting countries.

International equity: An interpersonal equity concept that takes into account both domestic and foreign taxes.

International (or world-wide) efficiency: The most efficient possible allocation of resources from the point of view of the world as a whole.

Locational neutrality: See Capital-export neutrality.

National efficiency: The most efficient possible allocation of resources from the point of view of New Zealanders.

National equity: An interpersonal equity concept that takes into account only domestic taxes.

National welfare maximisation: See National efficiency.

Neutrality: A tax is said to be neutral if its imposition does not alter the economic decisions that would be taken in its absence. (If it is assumed that the best of all possible economic world's would exist in the absence of taxes, neutrality is equivalent to efficiency.)

Nexus: The legal basis for subjecting a transaction (or entity) to tax.

Nondiscrimination principle: A generally-accepted notion that all domestically-incorporated firms, whether foreign-owned or not, should be taxed in the same way.

Overall limitation: A provision under which all foreign taxes paid may be pooled and offset against domestic taxes due on total foreign income.

Per country limitation: A provision under which the foreign taxes paid in a particular country are creditable only against domestic taxes due on income accruing from that country.

Permanent establishment: A concept used to determine when an enterprise has sufficient connection (nexus) with a jurisdiction to subject it to tax e.g. the maintenance of a permanent sales office.

Place of incorporation test: A rule under which companies are deemed residents of the country in which they are incorporated.

Portfolio investors: Foreign investors who are presumed to be passive recipients of dividend flows from investment abroad, and to exert no control over such investments.

Resident (or home) country: The country in which the owner of a foreign investment is located.

Residence principle: A principle of taxation under which all income accruing to residents of a country, regardless of its source, is subject to tax.

Seat of management test: A rule under which companies are deemed residents of the country in which they are held to be controlled or managed.

Separate entity approach: The treatment of the different components of multinational firms as though they are completely separate entities, operating at arm's length.

Source (or host) country: The country in which a foreign investment is located.

Source principle: A principle of taxation under which residents and non-residents alike are taxed only on income arising from sources defined as being within a particular country.

Subsidiaries: Firms that are wholly - or partly - owned by foreigners but are incorporated in the country in which they operate.

Tax havens: Companies incorporated in countries which subject income (or some forms of income) to low or negligible taxation.

Tax distortions: See Excess burden.

Thin capitalisation rule: A provision that limits the deductibility of interest by subsidiaries of foreign firms by requiring that their capital structure reflect a specified equity participation (debt-equity ratio).

Transfer pricing rules: see Arm's length pricing.

Treaty shopping: A term used to describe the attempt to link particular deductions (e.g. for interest) to particular outlays (e.g. for investment).

Unitary approach: A rule that attributes the deductions (or profits) of a multinational firm to its component parts in accordance with a formula based on such observable characteristics as sales, assets, or employment.

Withholding tax: A tax levied by the host country on profits, interest, or other payments to residents of foreign countries.

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