The Case for Residency-Based Taxation of Financial Transactions in Developing Countries

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[I will present this paper at the OECD INTR (International Network for Tax Research) conference at the University of Michigan on November 3-5 (see attached agenda). As you can see from the agenda, presenters in the conference will be leading scholars from all over the world, and I am very fortunate to be one of them.]

I. Introduction

The globalization process does not permit a country that wishes to be involved in this process to take an independent stand in choosing its tax system, especially with respect to financial transactions. [1] Choosing tax rules that are unacceptable in the world's leading countries could adversely affect an economy's competitiveness in the world's capital markets.[2] The growth in international capital movements is a contributory factor in this respect.[3]

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[1] See *Harmful Tax Competition: An Emerging Global Issue (1998),* para 21 (Hereinafter "OECD Report (1998)") ("Globalisation has also been one of the driving forces behind tax reforms, which have focused on base broadening and rate reductions, thereby minimising tax induced distortions. Globalisation has also encouraged countries to assess continually their tax systems and public expenditures with a view to making adjustments where appropriate to improve the 'fiscal climate' for investment. Globalisation and the increased mobility of capital has also promoted the development of capital and financial markets and has encouraged countries to reduce tax barriers to capital flows and to modernise their tax systems to reflect these developments. Many of these reforms have also addressed the need to adapt tax systems to this new global environment.").

[2] Id. para 22 ("The process of globalisation has led to increased competition among businesses in the global market place.").

[3] See Reuven S. Avi-Yonah, : *Globalization, Tax Competition, and the Fiscal Crisis Of The Welfare State* 113 Harv. L. Rev. 1573, 1575-6 (2000) (Hereinafter "Avi Yonah (2000)") ("The mobility of capital has

In 1923, a committee comprised of four economists submitted a report to the League of Nations that set forth the basic principles underlying international tax principles, most of which still prevail today. [4] Upon the issuance of the League of Nations Report in 1923, two generally recognized regimes for international tax have emerged – residency (or global) and source (or territorial).[5] In a residency-based tax regime, residents are taxed on their worldwide income.[6] In contrast, in a territorial regime, residents are not taxed on foreign source income and foreign taxpayers are taxed on income generated in the source country.[7] Over the years, however, there has been a significant degree of convergence among countries; most tax jurisdictions, whether developed or developing, use both

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resulted in international tax competition, in which sovereign countries aim to attract both portfolio and direct investment by lowering their tax rates on income earned by foreigners."); Edwards, Chris and de Rugy, Veronique, *International Tax Competition: A 21st-Century Restraint on Government,* 27 Tax Notes Int'l 63, 67 (2002) (Hereinafter "Edwards and de Rugy (2002)") ("World economies have become more tightly integrated in recent decades. Rapid growth in cross-border investment has been a key dimension of that integration. In past decades, many countries erected barriers to foreign investment, but today most countries realize that foreign investment means new jobs, new factories, and access to leading-edge technology. As a result governments have removed the shackles they once placed on international investment flows.").

[4] See Report on Double Taxation, Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp, League of Nations Doc. No. E.F.S. 73.F.19, 40 (1923) (Hereinafter "League of Nations Report (1923)"). Professor Hugh Ault defines this report as "the intellectual base from which modern treaties developed." See Hugh J. Ault, *Colloquium on Corporate Integration: Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 Tax L. Rev. 565 (1992) (Hereinafter "Ault (1992)").

[5] See Jeffrey M. Colon, *Financial Products And Source Basis Taxation: U.S. International Tax Policy At The Crossroads,* 1999 U. Ill. L. Rev. 775, 780 (Hereinafter "Colon (1999)").

[6] See Gregory May, *The U.S. Taxation of Derivative Contracts*, 95 TNI 189-8 (This article is an updated version of the national report published in 85b Cahiers de Droit Fiscal International 615 (1995) for the 49th Congress of the International Fiscal Association on September 17-21, 1995, hereafter "May (1995)").

[7] Id. See also generally Reuven S. Avi Yonah, *The Structure of International Taxation: A Proposal for Simplification,* 74 Tex. L. Rev. 1301 (1996) (Hereinafter "Avi Yonah (1996)").

source and residence taxation to some extent.[8] Most countries follow an "international tax regime" in both their internal laws and tax treaties.[9]

The question addressed by this article is whether a developing country (hereinafter "Country D") is better off adopting a source-based or residency-based taxation regime (or a combination thereof) for cross-border financial transactions.[10] Financial transactions add an important dimension to the general conflict between source-based and residency-based regimes since money is fungible.[11] Thus, when a non-resident wishes to invest overseas, the investor can easily switch from one country to another, and will do so if the tax rules in Country D could result in a heavier tax burden.[12]

Nevertheless, for developing countries, choosing between source-based and residency-based taxation is not easy.[13] On the one hand, a source-based regime would allow Country D to keep more tax revenues from non-residents.[14] Assuming that Country D has source rules similar to the most other countries with respect to financial transactions, a source-based regime, would, therefore, allow Country D to tax income derived by non-

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[8] Avi Yonah (1996), at 1303-05 (describing this process as the creation of an "international tax regime.").
[9] Id. at 1303 ("[A] coherent international tax regime exists that enjoys nearly universal support and that underlies the complexities of the international aspects of individual countries' tax systems.")
[10] See generally Avi Yonah (2000) at 1639-48 (discussing the pros and cons of the two alternatives); Victor Thuronyi *Taxation of New Financial Instruments*, 24 Tax Notes Int'l 261 (2001) (Hereinafter "Thuronyi (2001)").
[11] Id. See also Yaron Reich *Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities,* 98 TNT 114-71 (Hereinafter "Reich (1998)") ("One important policy consideration would seem to favor having the source country forgo the taxation of passive income, particularly portfolio investment income. Investment capital is highly mobile, and investors often can choose from among alternative investment opportunities around the world.").
[12] Edwards and de Rugy (2002) at 67 ("Portfolio flows can be shifted in and out of foreign investments quickly and are more sensitive to short-term returns than is FDI.").
[13] See Avi Yonah (2000) at 1639-48. As to financial transactions in particular, see Thuronyi (2001).
[14] Avi Yonah (2000) at 1640-41 (discussing the need for tax revenues in developing countries).

residents from interest and dividends.[15] On the other hand, non-residents from countries that have residency based taxation regime would be less inclined to invest in Country D, since their home country would impose tax on such non-residents' activity in Country D, and this might result in double taxation (if no applicable treaty applies, and there is no other relief for double taxation).[16] Furthermore, as set forth below, residency-based taxation promotes Capital Export Neutrality (CEN).[17] As this article concludes, the adoption of residency-based taxation for financial transactions by developing countries would benefit Country D.[18]

Residency-based taxation for financial transactions is generally consistent with the principle established by the League of Nations Report (1923) pursuant to which passive income should generally be taxed by the residency country.[19] Residency-based taxation for financial transactions would also make Country D's tax rules consistent with the current rules in the majority of developed countries (see Table 1 below), and reduce compliance costs, since the source-based taxation on interest and dividend income earned by nonresidents is very impractical in many instances. Residence-based taxation,

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[15] Id.

[16] Id. at 1641-48.

[17] See Avi Yonah (2000) at 1605, quoting Assaf Razin & Efraim Sadka, *International Tax Competition and Gains from Tax Harmonization*, 37 Econ. Letters 69, 69-70 (1991) ("If a country adopts the residence principle, taxing at the same rate capital income from all sources, then the gross return accruing to an individual in that country must be the same, regardless of which country is the source of that return. Thus, the marginal product of capital in that country will be equal to the world return to capital. If all countries adopt the residence principle, then capital income taxation does not disturb the equality of the marginal product of capital across countries which is generated by a free movement of capital.").

[18] Id. at 1582 ("The standard economic advice to small, open economies is to avoid taxing capital income at its source, because the tax will be shifted forward to the borrowers and result in higher domestic interest rates.").

[19] See Ault (1992) at 568 (stating that in the League of Nations Report (1923), "the right to tax business income, including the income of affiliated companies, was assigned to the source state. The right to tax income from business securities, however, was assigned exclusively to the residence state.").

however, would shift revenue from developing to developed countries in the short-run, but as discussed below, it would benefit Country D in the long-run.

In adopting residency-based taxation regime for financial transactions for purposes of encouraging foreign investment, Country D would not be alone.[20] "Over the last eighty years, the United States has encouraged passive foreign investment in U.S. capital markets by generally exempting foreign investors from U.S. tax on all income arising from dealings in U.S. debt and equity securities. [footnote omitted] This tax policy reflects a view that the benefits from increased foreign investment, such as lowering the cost of capital for U.S. firms and increased market liquidity, outweigh any foregone tax revenue."[21] Similar preferences have been included in tax treaties to which the United States is a party.[22]

Part II of this article describes the fundamentals of source based and residency based taxation in general and for financial transactions in particular. Part III is divided into three chapters, each of which discusses one of the following tax issues: (i) taxation of portfolio interest and dividends and capital gains earned by nonresidents; (ii) taxation of cross-border derivatives; and (iii) taxation of non-residents trading or investing in securities in Country D.

[20] See Table 1 below (describing the withholding rates for interest and dividend income earned by non-resident in several countries).
[21] See Colon (1999) at 783.
[22] Id. at 785 ("The favorable tax treatment of foreign investment reflected in the Internal Revenue Code also parallels the favorable tax treatment ac corded passive foreign investment income in bilateral income tax treaties, which generally exempt or significantly reduce source basis taxation on investment income earned by foreign persons.").

The United States has recognized the need to attract foreign lenders when it enacted the portfolio interest exemption in 1984.[23] In addition, the United States has enacted other provisions that exempt portfolio investment including: (i) the exemption for interest paid on bank deposits,[24] (ii) the exemption for original issue discount ("OID") on a debt obligation having an original maturity of 183 days or less,[25] and (iii) the exemption for most capital gains of foreign investors.[26] As discussed in greater detail below, many countries have followed the United States in enacting low or zero withholding tax on interest paid to non-residents.[27]

As intended, the enactment of the portfolio interest exemption has resulted in a significant increase in portfolio investment in the United States.[28] Chapter III(B) proposes an exemption for portfolio investment in bonds AND stock of domestic corporations; if Country D wishes to encourage foreign investors to lend money to domestic companies or to invest in such companies' stock, it should exempt portfolio interest and dividends income derived by such foreign investor as well as capital gains on sales of such instruments.[29]

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[23] Sections 871(h); 881(c). All "Section" references in this article are to the United States Internal Revenue Code of 1986, as amended (the "Code") or, when in the form "Treas. Reg. §," to Treasury regulations thereunder.

[24] Sections 871(i); 881(d).

[25] Section 871(g)(1)(B)(i).

[26] Sections 871(a)(2), 881(a).

[27] See Table 1 below. See, also Avi Yonah (2000) at 1581 ("The United States's enactment of the portfolio interest exemption has resulted in a classic 'race to the bottom.' One after another, all the major economies have abolished their withholding taxes on interest for fear of losing mobile capital flows to the United States.").

[28] Avi Yonah (1996) at 1315; Edwards and de Rugy (2002) at 86.

[29] Edwards and de Rugy (2002) at 86 (For this purpose, "The term portfolio investments is used . . . to describe investments in stocks and debt and other securities of U.S. issuers (and derivatives relating thereto) by non-U.S. persons that do not directly, indirectly, or constructively own a substantial equity

The United States has yet to adopt portfolio dividend exemption, but this article suggests that Country D will apply equal treatment for income from interest and dividends.[30] With respect to capital gains from selling bonds and stock of local companies (other than inventory), most countries including the United States have viewed the source of such gains and losses as the seller's residency, and Part II of this article will suggest that Country D adopt this principle (again, leaving the sole jurisdiction to tax capital gains to the residency country).[31]

Chapter III(C) discusses taxation rules for cross-border derivatives.[32] In general, derivatives are mainly used for either hedging[33] or speculation purposes. With respect to hedging, it is generally accepted that risk management is a crucial element in every business's growth.[34] Thus, Country D would clearly want to encourage local businesses

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interest in the U.S. issuer, where such investments are not effectively connected with a U.S. trade or business of such non-U.S. persons.").

[30] See Reich (1998) (advocating a portfolio dividend exemption in the United States); Merrill, Peter R., Patrick, Robert J. Abd Belanger, Pete, *Tax Treaties in A Global Economy: The Case For Zero Withholding On Direct Dividends*, 5 Tax Notes Int'l 1387, 1389 (Hereinafter "Merrill et. al") ("The recent proliferation of free trade areas bolsters the argument for zero withholding on direct dividends. The full benefits of an integrated regional market require elimination of barriers to capital flows -- including withholding taxes -- as well as trade flows.").

[31] See generally Section 865(a).

[32] See, generally, David Rosenbloom, *Source-Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions*, 50 U. Miami L. Rev. 597 (1996) (Hereinafter "Rosenbloom (1996)"). See also May (1995).

[33] Rosenbloom (1996) at 597-98 ("A derivative financial instrument is a device used to shift risk from one party to another. On this fundamental point, derivatives resemble insurance, a concept familiar to anyone who has purchased a vehicle or home. In an insurance transaction one party pays a fee, or premium, to another. In return, the other party undertakes the risk of paying the first party up to a specified amount in the event of a specified occurrence (such as a theft or fire). If the occurrence comes to pass, the first party has a claim against the second, which gives value to the insurance contract. That value depends on, or derives from, the occurrence, which is typically beyond the influence or control of either party, and the extent of the resulting loss. If the occurrence does not come to pass, the contract expires without having any value to the first party. Yet, such a transaction is sensible because, during the specified period, the insured was relieved of the risk of suffering loss as a result of the specified event by shifting the economic burden of that risk to the insurer.").

[34] Colon (1999) at 777 ("Financial instruments permit firms to transfer financial price risks to other investors better able or more willing to bear such risks. Financial instruments help firms to lower their

to manage their risk by entering into derivatives with foreign counterparties (assuming that the local banks could not satisfy this need).[35] Nevertheless, foreign counterparties will hesitate to enter into hedging transactions with domestic businesses in Country D if income from such transactions will be subject to tax in the source country.[36] This article will suggest, therefore, that Country D establish that income from derivatives used for hedging would be taxed by the residency country of the recipient of the income.[37] Once again, the United States has adopted similar source rules for periodic income from notional principal contracts, with the clear purpose of allowing domestic business more access to the foreign derivatives markets.[38] As for other derivative contracts (options, forwards and futures), there are no specific rules, but in general, the income from such contracts is taxed by the residency country.[39] The result is that income from all types of derivative contracts that is not effectively connected to a trade or business is rarely taxed by the source country.[40] This will be my suggestion for Country D as well. With regard to derivatives entered into for speculation purposes, these rules would be covered under the proposal for securities trading set forth below.

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financing costs and hedge more efficiently in both specific transactions, such as the purchase or sale of products in foreign currency, as well as in strategic cash flow hedging.").

[35] See generally *Tax Aspects of Derivative Financial Instruments*, 49th IFA Cong. Res. (Cannes 1995) (Hereinafter "IFA Report (1995)"). See Thuronyi (2001) at 264.

[36] Id.

[37] Id. See e.g., Treas. Reg. 1.863-7(b) for a similar rule in the United States (that only applies to periodic payments on notional principal contracts). See also similar rules in Canada and the United Kingdom discussed below; Rosenbloom (1996) at 603 (stating that the "international consensus" is that the source country does not impose tax on income from derivatives earned by non-residents).

[38] See Reich (1998) ("The rules for determining the source of income from notional principal contracts offer another example of the favorable tax treatment of foreign investors.").

[39] See Reuven S. Avi Yonah and Linda Swartz, *U.S. International Tax Treatment of Financial Derivatives*, 97 TNT 64-91 (Hereinafter "Avi Yonah and Swartz (1997)") (discussing the source rules for derivatives in the United States and generally concluding that the United States rarely taxed income from derivatives earned by non-residents, unless such income is effectively connected to a US trade or business).

[40] The only notable exceptions are significant nonperiodic payments that are treated as embedded loans and, therefore, are sourced according to the residence of the payor. See Id.

I would also suggest that that tax treaties include similar provisions. As of today, only a few countries have source rules for income from derivatives, and tax treaties still do not address the allocation of tax on such income.[41] My proposal would, therefore, be that treaties contain a specific provision to deal with income from derivative transactions.

Chapter III(D) discusses taxation rules applicable to those non-residents who generally invest or trade (as opposed to deal) in securities (including derivatives) in Country D. In general, participation of non-residents in the domestic securities markets will clearly increase the quantity and quality of trades in the domestic markets. Such an enhancement in the capital markets' activity would clearly benefit all investors in Country D's capital markets, domestic and nonresidents, since it will make the markets more liquid and efficient. Having liquid and efficient capital markets has been viewed as an important element in developing countries' economic growth. The United States has also recognized the benefit of foreign participants in the domestic stock markets and determined that such activity does not constitute a U.S. trade or business.[42] This article will suggest a similar approach; Country D should establish that all income from trading in securities, including capital gains, interest, dividends, and income from derivatives, would be taxed by the residency country.

Part IV discusses the question whether the above three suggestions would result in Country D's engagement in a "harmful tax competition," using the principles set forth by

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[41] See May (1995); Thuronyi (2001).

[42] See section 864(b)(2)(A) and (B). See also Linda Carlisle, *Derivatives Trading Now Has a "Safe Harbor*", 16 J. Tax'n Inv. 178 (1999) ("Since the Revenue Act of 1936, the U.S. tax laws have encouraged foreign investors to conduct securities and commodities trading activities in the U.S. by providing "safe harbors' that exempt gains realized from such trading activities from U.S. tax.").

the OECD in its 1998 landmark report on harmful tax competition.[43] I conclude in this part that if Country D adopts my suggestions, it will not be treated as engaging in harmful tax competition.

Part V will conclude that to sustain economic growth, country D should adopt residency-based taxation for financial transactions, which would allow it to attract foreign investors. In particular, the benefits for the developing country would be: (i) allowing domestic companies to raise capital by issuing bonds or stock to foreign investors, for lower finance costs; (ii) allowing domestic companies access to the global derivatives markets, which will enhance their risk management activity; and (iii) allowing nonresidents more access to the domestic capital markets, which would enhance the efficiency and liquidity of the markets.

II. Basic Principles of International Tax Rules

A. Overview

The fundamental distinction underlying the international tax regime of every country is between residency-based (or global) regime and source-based (or territorial) regime.[44] Every tax jurisdiction must, therefore, make a choice between one of these two regimes

[43] OECD Report (1998).

[44] See, generally, the League of Nations Report (1923), which established two bases for a country's imposition of tax: where income is produced (the source jurisdiction) and where it is consumed or saved (the residence jurisdiction). Id. at 25. See also Colon (1999) at 780.

or a combination thereof. Graetz and O'Hear (1997) described the basic dilemma of international taxation that each country faces as follows:

> Despite the seismic changes in the world economy that have occurred in the last seven decades, the fundamental dilemma of international taxation that confronted Thomas Sewall Adams, his Treasury colleagues, and the Congress in the infancy of the income tax remains essentially unchanged. When income is earned in one country by a citizen or resident of another country, both the country where income is earned (the source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income. The basic task of international tax rules is to resolve the competing claims of residence and source nations in order to avoid the double taxation that results when both fully exercise their taxing power.[45]

The influential League of Nations Report (1923) established the "doctrine of economic allegiance" principle pursuant to which there are four sources for justification of taxation: (1) Production of wealth; (2) Possession of wealth; (3) Enforcement of rights over property; and (4) Disposition of wealth.[46] The League of Nations Report (1923) gave equal treatment to all four, but as of today, most countries apply only one of the two regimes: residency or source, or a combination thereof.[47]

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[45] Michael J. Graetz and Michael M. O'Hear, *The'Original Intent' of U.S. International Taxation,* 46 Duke L.J. 1021, 1033 (1997) (Hereinafter "Graetz and O'Hear (1997)")
[46] League of Nations Report (1923) at 25.
[47] See Avi Yonah (1996), at footnote 10.

The League of Nations Report (1923) also discussed the issue of double taxation.[48] Obviously, if all countries apply the same regime (or if all countries sign tax treaties with each other), then double taxation will never arise. Nevertheless, since countries are free to choose whatever regime they want, and the treaty network is still incomplete, then double taxation will frequently arise. The classic double taxation situation arises when a resident of Country B (whose international tax regime is residency-based regime) derives income that is sourced in country D.[49] In this case, Country D would most likely wish to tax such income as the source country, while Country B would wish to tax the same income as the residency country. In the absence of a treaty, the taxpayer could be subject to double taxation on the same exact income.

The League of Nations Report (1923) generally concluded that the source country should have the first priority to tax income derived therein because it can generally impose its taxes on income deriving from within it first.[50] Nevertheless, the League of Nations Report (1923) also suggested that income items should be classified according to whether the primary economic activity giving rise to the income takes place in the source country

[48] League of Nations Report (1923) at 40-42.

[49] Other two potential double taxation situations are: (i) residence-residence: when two countries can claim residence as jurisdiction on the same individual or corporation; and (ii) source-source: when two countries each claim to be the source of the income. This could arise if income is derived from a process that takes place in more than one country. Those are the ones that are most difficult to resolve, as a practical matter, and usually result in actual double taxation.

[50] League of Nations Report (1923) at 40 ("A survey of the whole field of recent taxation shows how completely Governments are dominated by the desire to tax the foreigner... From this flows the consequence that, when double taxation is involved, Governments would be prepared to give up residence rather than origin as establishing the prime right.").

or in the residence country.[51] This division is generally referred to as between active and passive income (discussed in greater below).[52]

B. Source-Based and Residency-Based Taxation

In a residency-based tax regime, residents are taxed on their worldwide income, while non-residents are taxed only on their income derived in the source country.[53] Examples of countries utilizing this regime are the United States, Japan and the United Kingdom.[54] In contrast, in the case of source-based taxation, residents are not taxed on foreign source income and non-residents are taxed on income generated in the source country. [55] Examples of countries utilizing the source-based regime are France and the Netherlands.[56] Nevertheless, most countries apply a combination of these two regimes.[57] Global regimes very frequently allow for deferral or an exemption for active income that is earned through foreign subsidiaries; thus, certain foreign source income is not taxed by global regimes.[58] In addition, there are certain forms of foreign source passive income of residents that are taxed even by territorial regimes.

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[51] Id. at 40-2.
[52] Id. See generally Avi Yonah (1996).
[53] Daniel Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, Tax Notes, Apr. 30, 1990, p. 581 (Hereinafter "Frisch (1990)"); Colon (1999) at 780; Rosenbloom (1996) at 605-6.
[54] See Frisch (1990). See also Edwards and de Rugy (2002) at 83.
[55] See Edwards and de Rugy (2002) at 83.
[56] Id. at Table 10-2. Territorial regimes seek to tax all taxpayers including resident taxpayers only on domestic (e.g., French) source income. Thus, all taxpayers whether reside in France or abroad, only pay tax on French source income. Id.
[57] Edwards and de Rugy (2002) at 83.
[58] For example, in the United States, a U.S. resident that earns foreign source active income directly is subject to U.S. tax. Nevertheless, if the U.S. resident owns 100% of the shares of a foreign corporation (which under U.S. law is not a U.S. resident), fundamentally, even though the U.S. resident controls the shares of the foreign corporation, the corporation is treated as a separate legal entity from the shareholder. Thus, income earned by the corporation is not subject to U.S. tax because it is foreign-source income of a non-resident. The shareholder, therefore, can shift the income to the corporation. If the corporation were

Source-based taxation has been generally justified on the grounds that the source country provides the taxpayer (resident or non-resident) with benefits that allow such taxpayer to generate the income.[59] Source-based taxation is also consistent with the concept of capital import neutrality (CIN).[60] Residency-based taxation, on the other hand, has been generally justified on the grounds that it is consistent with the ability-to-pay principle (equity) and that it promotes efficiency in the form of capital export neutrality (CEN).[61] It is generally accepted that CEN is the better guide for cross-border investment (both direct and portfolio investment).[62]

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incorporated in a "tax haven," the result would be no current taxation of the foreign source income of the corporation, which is equivalent to a tax exemption for the interest on these earnings for the period of deferral. This would amount to virtually complete exemption in present value terms if the deferral lasts long enough. U.S. tax will be imposed only on one of two events: (i) either when the foreign corporation actually pays the dividends to the U.S. resident - then there is tax because this is income of the U.S. resident; and (ii) alternatively, the U.S. resident can sell the shares, and that would be a capital gain subject to tax too, although at a reduced rate of tax under U.S. rules. Those two events certainly would trigger the tax, but both of these events also are completely under the control of the U.S. resident. The U.S. Code contains a complex set of overlapping anti-deferral regimes, all of which result either in current taxation of the foreign source income to controlling US shareholders or in an interest charge on the income when it is repatriated to the U.S.

[59] Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies,* 54 Tax L. Rev. 261, 298 (2001) (Hereinafter "Graetz (2001)") ("The idea that the source country has a fair claim to the income produced within its borders is also grounded in the view that foreigners, whose activities reach some minimum threshold, should contribute to the costs of services provided by the host government, including, for example, the costs of roads and other infrastructure, police and fire protection, the system for enforcement of laws, education, and the like. The services a nation provides may contribute substantially to the ability of both residents and foreigners to earn income there."); Colon (1999) at 781 ("Source basis taxation is explicitly tied to a benefit and burden rationale of taxation; the source country has provided either services or protection that have enabled the income to be earned and therefore has the primary right to tax such income.").

[60] See, generally Frisch (1990) at 587-91.

[61] See Merrill et.al. at 1389 ("'Efficiency' refers to the allocation of capital to its most productive uses, i.e., those that result in the highest pre-tax rate of return. In an international context, efficiency requires that the effective tax rate on investment abroad by a U.S. company be equal to the effective tax rate on domestic investment, a principle referred to as capital export neutrality (CEN).").

[62] See Avi Yonah (2000) at 1610.

In general, "[t]he United States exercises income tax jurisdiction on both a source and a residence basis.[63] Pursuant to Section 61: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived…" Section 2(d), however, mandates that "[i]n the case of a nonresident alien individual, the taxes imposed by sections 1 and 55 shall apply only as provided by section 871 or 877."[64] The United States Internal Revenue Code, therefore, limits the tax liability of non-resident individuals (section 2(d)) and foreign corporations (section 11 (d)), to U.S. source income by reference to sections 871 or 877 (individuals) and 882 (corporations).[65] Thus, while U.S. residents are taxed on their worldwide income, for non-resident aliens, the tax is limited to US source income.[66]

C. Active v. Passive Income

Consistent with the "international tax regime," in the vast majority of countries including the United States, passive income and active income are subject to different treatment.[67]

[63] May (1995) ("Source-based jurisdiction applies to the fixed or determinable periodic amounts realized from U.S. sources by nonresident foreign persons. Residence-based jurisdiction extends to U.S. citizens and residents, domestic corporations, and foreign persons doing business in the United States."). For an excellent overview of the U.S. international tax regime, see JCT *Reports on International Taxation* (JCX-40-99), 1999 TNT 124-8 (Hereinafter "JCX 40-99").

[64] Non-residents are generally taxed on all income that is effectively connected with the conduct of a trade or business in the United States. See section 864(c)(4).

[65] A foreign person is engaged in a U.S. trade or business if her activities (or the activities of an agent acting on her behalf) are considerable, continuous, and regular. See *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940). Foreign persons engaged in a U.S. trade or business are taxed at graduated rates on income effectively connected with such trade or business. See section 864(c); Treas. Reg. § 1.864-3-7. In computing effectively connected income, foreign persons are allowed to deduct allocable expenses. *See* sections 873 and 882(c).

[66] For the definition of "non-resident alien," see section 7701(b)(1)(B) (defining who is a nonresident alien individual) and Section 7701(a)(5) (defining what is a foreign corporation and partnership).

[67] See Reich (1998) ("Broadly speaking, income can be divided into two categories: active and passive. Active income corresponds to earned income from the conduct of business activities, including receipts of a business enterprise and wages of an individual. Passive income is investment income, such as interest,

This distinction is contained not only in domestic laws but also in all three treaty models.[68] In most cases, determining what types of income constitute "passive" income and what types of income constitute "active" income is easy; the test is whether the activity that gives rise to the income is such that a taxpayer *controls* it.[69] In the case of passive income, the taxpayer generally has no or little direct control over the production of income.[70] Common examples of passive income include income from dividends, interest (including OID), rent and royalties.[71] In the case of active income, generally, the taxpayer has direct control over the production of income. Examples of active income include income from services and business income.[72]

In accordance with the "international tax regime", the fundamental principle in most countries, as reflected not only in domestic laws but also in numerous tax treaties, is that active income is taxed primarily at the source (where the activity took place), while passive income should be taxed at the residency country, where it reflects a return on capital.[73] This concept was introduced by the League of Nations Report (1923).[74] In general, the League of Nations Report (1923) established that the source country should have the first right to tax (the "first bite" principle).[75]

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dividends, and gains from the sale of stocks and security that is not earned by the taxpayer in the ordinary course of business (for example, as a securities dealer or a bank)").

[68] Avi Yonah (1996) at 1306-07.

[69] Id. at 1309-10.

[70] This is generally referred to as "portfolio" income. Id.

[71] Id. See also Reich (1998).

[72] Id.

[73] See generally Avi Yonah (1996); Reich (1998).

[74] See Avi Yonah (1996) at 1305-06, citing the League of Nations Report (1923) at 18.

[75] In the absence of a treaty, it is the obligation of the residency country to alleviate double taxation by either (i) exemption of the foreign source income, or (ii) foreign tax credit. See League of Nations Report (1923) at 40.

The United States generally follows the active/passive distinction; passive income (generally referred to as "FDAP" income - fixed, determinable, annual or periodic) is subject to a gross based withholding tax and no deductions are allowed. [76] Pursuant to sections 1441 and 1442, U.S. withholding tax applies to a payment if: (i) the payment constitutes a fixed or determinable annual or periodical amount (FDAP); (ii) the payment has a United States source; and (iii) the payment is not effectively connected to a United States trade or business.[77] If all three requirements are satisfied, a withholding tax of 30 percent applies, unless the rate is reduced by an applicable income tax treaty.[78]

Congress and Treasury can exempt non-resident taxpayers from withholding tax by either (i) exempting a certain type of income from the FDAP definition,[79] or (ii) setting forth that a certain type of income is not U.S. source income.[80] Further, Congress and Treasury may provide that certain activities will not give rise to a trade or business in the United States.[81]

On the other hand, in the United States and also consistent with the "international tax regime," active income (*i.e.,* income effectively connected with a U.S. trade or business)

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[76] See section 871(a) pursuant to which income of non-residents not connected with a US trade or business, other than capital gains, is subject to a 30 percent gross tax. In contrast, under section 871(b), income of non-residents which is connected with a U.S. trade or business is subject to graduate rate of tax (i.e., net tax), similar to the rates that apply to residents.

[77] Reg. § 1.1441-2(a).

[78] Section 871(a).

[79] *See* Reg. 1.1441-2(b)(2)(i), exempting from the FDAP income definition gains derived from the sale or property, including market discount and option premiums). *See also* section 871(h) (portfolio interest exemption) and sections 871(i)(2)(A) and (B), pursuant to which there is no withholding tax on U.S. source interest paid by U.S. banks and on dividends paid by U.S. corporations with significant foreign business activities.

[80] For example, pursuant to sections 861(a)(1)(A) and (B), interest paid by a U.S. taxpayer with significant foreign business activities to a foreign person is foreign rather than U.S. source income, contrary to the general source rules pertaining to interest.

[81] See the discussion below pertaining to the securities trading safe harbor under sections 864(b)(2).

is taxed as if it were income of a U.S. resident--that is, it is taxed at the graduated rate that applies to residents.[82]

Tax treaties generally follow the same approach; rather than giving the source country the first bite and allowing credit or exemption in the residency country, treaties simply provide for primary jurisdiction to tax active income to the source country, and primary jurisdiction to tax passive income to the residency country.[83]

In particular, tax treaties reflect the active or passive distinction in two ways: (i) define what constitutes an active business operation in a given country (a "permanent establishment")[84] and give the source country the primary right to tax the income that is attributable to that operation; and (ii) seek to reduce as much as possible the taxes levied by the source country on passive income (such as income from dividends, interest, and royalties) derived from within it, leaving the right to tax that income to the residence country.[85]

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[82] Sections 871(b) (Individuals) and 882 (a) (Corporations).

[83] Organization for Economic Co-operation and Dev., Model Tax Convention on Income and Capital, 1 Tax Treaties (CCH) P 191 (Sept. 1, 1992) (Hereinafter "OECD Model Treaty"), Articles 7, 10, 11 (providing that passive income be taxed by the residency country while active income may be taxed in the source country); United Nations Dep't of Int'l Economic & Social Affairs, United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) (Hereinafter "U.N. Model Treaty"), Articles 7, 10, 11 (generally following in general the OECD Model Treaty, but advocating more source-based taxation of passive income); Internal Revenue Service, U.S. Treasury Dep't Convention Between the United States of America and for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, 1 Tax Treaties (1996) (Hereinafter "U.S. Model Treaty"), Articles 7, 10 and 11 (applying the same principles).

[84] OECD Model Treaty, Articles 5 and 7; U.N. Model Treaty, Articles 5, 7; U.S. Model Treaty, articles 5, 7 (All defining "permanent establishment"). The U.N. Model Treaty attempts to lower the threshold of the permanent establishment standard, thereby allowing developing countries more source-based taxation.

[85] See OECD Model Treaty, Articles 10(2)(b) (dividends), 11(2) (interest) and 12(1) (royalties); U.N. Model Treaty, Articles 10-12; U.S. Model Treaty, Articles 10-12.

According to Professor Avi Yonah (1996), the tax treaties do not completely achieve their goal of dividing the worldwide taxing jurisdiction between source and residence countries.[86] First, the permanent establishment concept reflects a compromise: not all active business income is taxable primarily in the source country but rather only income that is attributable to a permanent establishment.[87] Second, the taxation of passive income at its source is not completely abolished, but it is reduced in most treaties to the lowest possible levels (0%-15%).

D. The Rationale Behind the Active/Passive Distinction

In general, the different treatment of active and passive income in domestic laws and tax treaties has been justified on several grounds. First, the taxation of active business income represents the taxation of the profits of the firm while the taxation of passive income represents the taxation of the division of those profits.[88]

Second, the generation of active income is generally under the taxpayer's control while the generation of passive income is generally in the form of "portfolio" income.[89] For this purpose, "portfolio" income does not include income derived by controlling shareholders,

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[86] Avi Yonah (1996) at 1307-08.

[87] Some treaties, especially under the U.N. Model treaty, contain a "force of attraction" rule, as discussed below.

[88] Michael Graetz and Itai Grinberg, *Taxing International Portfolio Income*, 56 Tax L. Rev. 537, 547 (2003) (Hereinafter "Graetz and Grinberg (2003)"). ("It may be simpler analytically, however, to regard income from [foreign direct income] as representing the profits from conducting business activities abroad - the profits of the firm - and income from [foreign portfolio income] as representing passive investment income - the profits realized by investors in the firm."), citing Avi Yonah (1996) at 1308-10. The problem is where there might be multiple sources of income (for example, interest): both where the capital is used and where the capital was accumulated. Avi Yonah (1996) at 1309.

[89] Avi Yonah (1996) at 1309. See also *Background and Issues Relating to the Taxation of Foreign Investment In The United States* (JCS 1-90) ("The portfolio investor generally does not have control over the assets that underlie the financial claims.").

since in such a case, even passive income (e.g., dividends) would be under the control of the recipient.[90]

Finally, another justification for the distinction between active and passive income relates to who earns the income; while active income is earned basically by large, publicly traded corporations, passive income is earned by individuals or small corporations.[91]

E. Residency-based Taxation?

While this article focuses residency-based taxation for financial transactions, some of the arguments for more general residency-based taxation may also support this article's conclusions.[92] Many commentators over the years have advocated the adoption of pure residency-based taxation.[93] As set forth above, one of the major arguments in support for such a regime is that residency-based taxation promotes equity since the ability-to-pay principle is violated in a source-based taxation regime.[94] Furthermore, a pure residency-based regime is more efficient because it is compatible with the goal of capital export neutrality (CEN), which requires that the decision to invest in a given location not be affected by tax rates.[95]

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[90] Id.
[91] Graetz and Grinberg (2003), at 547 ("Foreign portfolio income often is earned today by both individuals and corporations, while FDI virtually always is made by corporations.").
[92] See generally, Graetz and O'Hear (1997) at 1033-41 (Describing the history of the United States' international tax policy and the support for the residency-based regime).
[93] Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 Cornell L. Rev. 18, 29 (1993).
[94] Id.
[95] Graetz (2001) at 270 ("Achieving [worldwide] efficiency typically is said to involve two kinds of neutralities. The first is capital export neutrality (CEN), which is neutral about a resident's choice between domestic and foreign investments providing the same pretax rates of return. CEN requires that a resident of

Thus, elimination of withholding taxes by the source country promotes optimal allocation of capital investment across countries:

> Assuming that withholding taxes at source under bilateral agreements generally are modest (or nil) and creditable against the tax liability in the residence country, the taxes at home will determine the overall tax level on the saver, independent of the source of the income. In this situation, interest arbitrage will tend to equalize pretax rates of return internationally. As the gross return to capital in equilibrium is equal to the marginal product of capital, it follows that a universal use of the residence principle will result in equalized marginal products of capital across countries, and thus entail an optimal international allocation of investment, maximizing future world output.[96]

Residence-based taxation is also simpler because countries will not need to establish source rules; residents will be taxed on their worldwide income regardless of where the source is. Finally, if each country taxes only its own residents and all countries agree on the definition of a "resident" there should be no dual residency problems.

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any nation pays the same marginal rate of income taxation regardless of the nation in which she invests. CEN is not only neutral about where such investments are made but also is indifferent about which country collects the tax revenue when capital originating in one country produces income in another. Typically, economists regard CEN as essential for worldwide economic efficiency, because the location of investments would be unaffected by capital income taxes.").

[96] Norregaard, John *Tax Treatment Of Government Bonds*, 15 Tax Notes Int'l 143, citing Razin, Assaf, Efraim Sadka, and Chi-Wa Yuen, 1996, 'A Pecking Order Theory of Capital Inflows and International Tax Principles,' IMF Working Paper 96/26 (Washington: International Monetary Fund), Tax Notes Int'l, Jan. 1, 1996, p. 47.

F. Determining the Source of Income

Unless all countries move to a pure residency-based taxation, source rules would be required to determine which country has the first jurisdiction to tax an item of income.[97] In the vast majority of countries, however, most types of income and deductions do not have a defined source, and the source is therefore determined on a case-by-case basis. With respect to complicated items of income or deductions defining the source is very difficult and it is hard to pinpoint the correct economic source.[98]

In many countries including the U.S., source rules can be divided in two categories: (i) formal rules, and (ii) economic rules. Formal rules do not attempt to trace the economic source of the income but seek to achieve administrative ease and certainty. Economic rules, on the other hand, do attempt to trace the economic source of the income, but result in more litigation and uncertainty.

The main difference between the formal and economic rules is that the formal rules are relatively easy to administer from both the taxpayers' and the tax authorities' perspectives because they are bright line rules and simply require one single determination such as residence of the payor, residence of the seller or passage of title, to

[97] See May (1995) ("Source rules play a critical role in defining the scope of U.S. tax jurisdiction. They identify the U.S.-source income over which the United States asserts primary jurisdiction. They also determine the extent to which, through the foreign tax credit system, the United States will curtail its residence-based claims and effectively yield tax jurisdiction to a source country.").

[98] See JCX-40-99 ("The source of income for U.S. tax purposes is determined based on various factors. The relevant factors include the location or nationality of the payor, the location or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of the assets that generate the income.").

establish the source. The economic rules, on the other hand, involve much more difficult determination such as where a patent or copyright was actually used, which is sometimes not easy to determine, especially if it is used in many countries. Economic source rules are therefore tougher to avoid by the taxpayer because as opposed to formal rules, they are not significantly under the taxpayer's control.

G. The Role of Tax Treaties in Allocating Income Between the Source and Residency Country

According to Professor Hugh Ault, "From the beginning, treaties have involved the allocation of taxing claims and the international division of revenue."[99] As set forth above, in the absence of a treaty between the source country and residency country, the source country has the right to tax all income (passive and active) derived therein.[100] To serve its most important role of preventing double taxation, tax treaties generally shift tax revenue from the source country to the residence country by forcing a rule pursuant to which active income is taxed on source but only if it is attributable to "permanent establishment," while passive income (*e.g.*, interest and dividend) is barely taxed at source at all.[101] This division was also established by the League of Nations in 1928, in its first model treaty, as described in more detail below. [102]

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[99] See Ault (1992) at 567.
[100] See League of Nations Report (1923).
[101] See Colon (1999) at 786 ("treaty signatories usually agree to eliminate or substantially reduce source basis taxation on income earned by residents of the other country, for instance, dividends, rents, royalties, and interest.").
[102] See Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations, Doc. C.562.M.178. 1928 II (Oct. 31, 1928) (Hereinafter "League of Nations Report (1928)").

Generally, in all existing treaties, passive income is mostly taxed by the residency country (rates at source are between 0%-15%), while active income is taxed by the source country.[103]

Source-based taxation of active income is limited under all three models to income that is "attributable" to a "permanent establishment" at the source country.[104] In both the United States and OECD models, there is no "force of attraction" rule; therefore, only income that is attributable to a permanent establishment is taxed by the source country, while income that is not attributable to such permanent establishment will be subject to the rates set forth in the treaty for other types of income.[105] As a result, whether the source country can tax a certain item of income would depend on how high the permanent establishment threshold is set. In general, the permanent establishment threshold for physical presence is higher than the U.S. trade and business requirement; thus, a treaty allows non-U.S. residents to conduct more business in the U.S. without being subject to tax in the U.S. (but may be subject to state taxes, because the treaty only covers federal taxes).

In 1928, the League of Nations issued a model for bilateral income tax treaty for the reciprocal relief of double taxation of international income, which still serves as the basis

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[103] Id. See also JCX 40-99.

[104] See JCX-40-99 ("Under the U.S. model, one treaty country may not tax the business profits of an enterprise of a qualified resident of the other treaty country, unless the enterprise carries on business in the first country through a permanent establishment situated there. In that case, the business profits of the enterprise may be taxed in the first country on profits that are attributable to that permanent establishment.")

[105] Id. Note that "The U.N. model adds a limited 'force of attraction rule' which would allow the country in which the permanent establishment is located to attribute to the permanent establishment sales in that country of goods or merchandise of the same or similar kind as those sold through the permanent establishment, and to attribute to the permanent establishment other business activities carried on in that country of the same or similar kind as those effected through the permanent establishment." Id.

for the model income tax treaties of the following models: (i) U.N. Model Treaty; (ii) OECD Model Treaty; and (iii) U.S. Model Treaty (for treaties to which the United States is a party).[106] Obviously, the U.N. Model Treaty is the most favorable to source countries, because it is designed for developing countries; the U.N. Model Treaty normally allows more source-based taxation than the U.S./OECD models.[107] The U.S. Model Treaty, on the other hand, is the least favorable to source countries, because it is designed for the US (a capital exporter).

The motivation of a developing country to enter into a treaty with a developed country is obvious; assuming that the latter is a capital exporter and the former is a capital importer country, a tax treaty creates stability. Many developing countries do not have stable regimes. A tax treaty protects foreign investors from sudden increases in the tax rates. Stability is often more important for US investors than the actual rates. Further, a tax treaty would provide foreign investors with information about current taxes. Finally, a tax treaty would bring the developing country closer to the community of developed countries.

[106] Graetz and O'Hear (1997) at 1023. See also JCX 40-99 ("The preferred tax treaty policies of the United States have been expressed from time to time in model treaties and agreements. The Organization for Economic Cooperation and Development (the 'OECD') also has published model tax treaties. In addition, the United Nations has published a model treaty for use between developed and developing countries. The Treasury Department, which together with the State Department is responsible for negotiating tax treaties, last published a proposed model income tax treaty in September 1996 (the 'U.S. model'). The OECD last published a model income tax treaty in 1992 ('the OECD model'). The United Nations last published a model income tax treaty in 1980 ('the U.N. model').").

[107] For example, the U.N. Model treaty increases the scope of permanent establishment to include more activities, such reducing the length of construction work that is viewed as a permanent establishment from 12 to 6 months

III. Taxation of Cross-border Financial Transactions

A. General

Income and deduction items from financial transactions generally include: (1) Interest and dividend income/deduction on debt and equity instruments (ordinary income); (2) ordinary income/deductions from other types of financial instruments (*e.g*., notional principal contracts); and (3) Capital gains/losses.

For each of the above items, there are three different tax related issues: (1) The character of the income (ordinary v. character), (2) The time when the income or deduction is recognized, and (3) Whether the income has domestic or foreign source (and whether it is taxed by the source country or not). [108] Numerous articles have been written on the issues of timing and character of income and deductions from financial transactions. This article focuses only on the third issue.

As of today, only a few countries have enacted a comprehensive set of rules pertaining to taxation of financial instruments.[109] As Victor Thuronyi indicates, however, not all countries need a comprehensive set of tax rules for financial instruments - "Countries that (i) do not have reduced rates (or exemption) for capital gains, (ii) base their corporate income tax on the financial accounting rules, and (iii) have kept their corporate income tax rules simple therefore may not need extensive special rules for [financial instruments]

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[108] See Thuronyi (2001) at 261.
[109] Id. These include the United States, United Kingdom, Canada, Australia and New Zealand.

in their domestic legislation."[110] Nevertheless, the increasing use of financial instruments in many countries, developed and developing, requires a new assessment of the need to at least establish basic principles for cross-border aspects.[111] Many countries have been updating their income tax systems to address the taxation of financial transactions.[112]

As opposed to taxation of cross border direct investment, the tax literature on taxation of portfolio investment is relatively thin.[113] Nevertheless, cross –border portfolio investment has been booming in recent years, and it can no longer be ignored.[114]

A fundamental distinction in the context of cross-border investment is between direct investment and portfolio investment.[115] "Portfolio investment" generally means "investments in stocks and debt and other securities of U.S. issuers (and derivatives relating thereto) by non-U.S. persons that do not directly, indirectly, or constructively own a substantial equity interest in the U.S. issuer, where such investments are not effectively connected with a U.S. trade or business of such non-U.S. persons.. . . the dividing line between portfolio investments and related-party investments varies, and may for example be 5 percent, 10 percent, or 50 percent, depending on the particular

110 Thuronyi (2001) at 264.
111 See e.g., the United Kingdom Finance Act of 2002 and the 2002 reform in the Israeli tax system, both discussed below.
112 Id. See also recent tax reforms in Mexico.
113 Graetz and Grinberg (2003) at 538.
114 Id.
115 Id.

statutory or regulatory provision."[116] Direct investment is generally any type of investment other than "portfolio investment."

Many countries (developed and developing) face a serious conflict between imposing higher rates on income sourced therein to generate revenue and providing tax relief to attract foreign investors.[117] In the case of financial transactions, the conflict becomes even harder, since money is fungible, and foreign investors can easily switch their investments from one country to another in response to tax burden.[118]

In 1991, the OECD praised the benefits of globalization :

> Capital markets in OECD countries are increasingly integrated as member countries have removed controls on international investment and foreign exchange regulations. At the same time, the proportion of international activities accounted for by large multinational enterprises (MNEs) has increased. One consequence of this gradual liberalization and globalization is that international capital flows may have become more sensitive to differences in the tax regimes between countries.[119]

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[116] See Reich (1998). See also JCX 40-99.
[117] See Leif Muten *International Experience of How Taxes Influence the Movement of Private Capital,* 8 Tax Notes Int'l 743, 744 (1994).
[118] Graetz and Grinberg (2003) at 549 ("In contrast [to direct investment], portfolio investment dollars are volatile and move rapidly throughout the world seeking the highest return possible for a given level of risk. [footnote omitted] In portfolios managed by investment professionals, investments in one foreign country are frequently interchangeable with investments in countries with similar risk/return profiles. [footnote omitted] One consequence is that portfolio investment dollars abroad may substitute for investments at home."
[119] Norregaard, John and Owens, Jeffrey, *Taxing Profits in a Global Economy*, 4 Tax Notes Int'l 491 (summarizing 'Taxing Profits in a Global Economy: Domestic and International Issues' (OECD 1992)).

Nevertheless, seven years later, the OECD Report (1998) on harmful tax competition also stated that "the process of globalisation has led to increased competition among businesses in the global market place."[120] Thus, the conflict that many countries face today is between reducing the tax burden of financial transactions to attract foreign investors and not being criticized at engaging in harmful tax competition.[121] My suggestion to Country D is to generally follow the footsteps of the United States in taxation of certain cross-border financial transactions. This way, it can successfully attract foreign investment, but will not be viewed as engaging in harmful tax competition.

B. Taxation of Interest, Dividends and Capital Gains

1. Taxation of Cross-border Interest and Dividends

In the United States as well as many other countries, the source of income from dividend and interest is the residency of the payor.[122] The rationale behind this formal rule is that it is administratively hard to tax interest from a foreign corporation to foreign holders, but easier to tax interest from a U.S. payor (using withholding). In contrast, as described in greater detail below, the source of income from a notional principal contract is the

[120] OECD Report (1998) para 22.
[121] See generally Avi Yonah (2000).
[122] Section 861(a)(1) (Interest) and 861(a)(2) (Dividends). See also JCX 40-99.

recipient's residency.[123] Other countries, such as Mexico for example, attempt to trace the economic source of interest income.[124]

Tax rates applicable to interest and dividend differ between countries; in some countries such income is taxed on the basis of the taxpayer's marginal rate while in others the ordinary rates applicable to interest and/or dividend are fixed.[125] Several countries have also adopted a regime pursuant to which the rate of tax applicable to capital gains is lower then the maximum ordinary rates.[126]

In the U.S., there are two possible tax regimes that could apply to non-U.S. residents deriving interest and dividends income in the U.S.: (i) non-U.S. persons that are engaged in a "trade or business" in the United States are subject to U.S. tax at the usual rates for individuals or corporations, as the case may be, on income that is "effectively connected" with such U.S. trade or business,[127] and (ii) non-U.S. persons that are not so engaged, or

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[123] Reg. 1.863-7.

[124] See Guerrero, Juan Carlos, *Mexico Publishes New Rules On Public Debt Instruments*, 38 Tax Notes Int'l 472 (April 28, 2005) ("Article 195 of the Income Tax Law establishes that for interest income, the source is considered to be located in Mexico if capital is placed or invested in Mexico, or if the interest is paid by a resident of Mexico or by a nonresident with a PE in Mexico. For that reason, if a Mexican resident pays interest to a nonresident, it will be considered Mexican-source income, and the nonresident will be required to pay income tax in Mexico on the interest payment."). Cf. Israel, where in 2003, newly added section 4A to the Income Tax Ordinance adopted source rules that are similar in many aspects to those in U.S. tax laws as well as under most treaties. In particular, the bill provides that the source of interest income is the place of residency of the debtor. See Keinan, Yoram and Katalan, Shlomo *Israel's Income Tax Reform: Roads Not Taken*, 28 Tax Notes Int'l 941 (Sept. 24, 2002).

[125] See Edwards and de Rugy (2002) at 79 ("Tax competition has spurred other tax reforms. A group of Nordic countries has installed dual income tax systems that feature a low flat rate on capital income (interest, dividends, and capital gains) but retain progressive rates on labor income. Denmark, Finland, Norway, and Sweden implemented such reforms a decade ago. The Netherlands and Austria have recently enacted similar reforms, and other European countries have moved in that direction.").

[126] See Keinan and Menuchin (2003).

[127] Section 864(c). As discussed above, in the case of a treaty, the standard would be income that is "attributable" to a "permanent establishment" in the United States.

that derive interest or dividend income that is not effectively connected, are subject to withholding tax of 30 percent (unless reduced by a treaty or applicable domestic rule).[128]

2. Taxation of Interest

Congress has generally exempted interest income (but not dividend income) derived in the United States by non-residents in two ways: (i) treating the income as non-U.S source income, or (ii) exempting such income from U.S. tax even if it is treated as U.S. source income.[129] Examples of the former are sections 861(a)(1)(A) and (B), pursuant to which interest paid by a U.S. taxpayer with significant foreign business activities to a foreign person is foreign rather than U.S. source income, contrary to the general source rules pertaining to interest.[130]

The most notable example of the latter is, of course, the "portfolio interest exemption," which is the most significant exemption from gross tax on FDAP income in the United States.[131] Since 1984, interest paid to a nonresident who does not control 10% or more of the payor is generally exempt.[132] Thus, interest on a loan from a foreign parent to a U.S. subsidiary is not exempt if the parent owns 10 percent or more of the US subsidiary's stock. Congress specifically indicated that the portfolio interest exemption was enacted "to allow U.S. corporations (and the U.S. Treasury) direct access to the Eurobond

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[128] Section 871(a)(1)(A) (Individuals); Section 881(b)(1)(A) (Corporations).
[129] See Colon (1999) at 783, note 25.
[130] Id. Another example discussed below is the source rules for income on a notional principal contract pursuant to Treas. Reg. 1.863-7 (residency of recipient). See also JCX 40-99.
[131] Id.
[132] Pub. L. No. 98-369, 98 Stat. 494. See also Avi Yonah (2000) at 1579-80.

market."[133] As two commentators indicate "The portfolio-interest exception is perhaps the purest example of enlightened self-interest and realism in attracting foreign capital."[134]

In general, under the portfolio interest exemption, interest earned by non-residents is exempt from withholding tax unless it is paid to: (i) a "10-percent shareholder" or other related person;[135] (ii) a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business;[136] or (iii) a controlled foreign corporation from a related person.[137]

With respect to tax treaties, the United States clearly follows the same principle – pursuant to the U.S. Model Treaty, the rate of withholding for interest under Article 11 should be zero.[138] The OECD Model Treaty permits up to 10 percent of withholding rate for interest,[139] and as illustrated in Table 2 below, it is very rare for interest income to be taxable at more than 10 percent by the source country. Finally, the U.N. Model Treaty

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[133] Joint Comm. on Tax'n, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p. 392 (the stated purpose of the exemption was "to allow U.S. corporations (and the U.S. Treasury) direct access to the Eurobond market."). See also the 1984 Joint Committee on Taxation (JCT) report accompanying the legislation (Tax Treatment of Interest Paid to Foreign Investors (JCS-23-84, April 28, 1984). ("if the primary effect of repeal is to cause foreign investors to shift from short to medium term U.S. securities . . . , then medium term interest rates would decline. . . . [T]his would benefit the US economy by stimulating investment in plant and equipment. . . . proponents of repeal of the . . . withholding tax argue that the attractiveness of U.S. bonds in the international bond market is greatly diminished by the withholding tax, so that the tax is a barrier to international trade in assets.").

[134] Dan R. Mastromarco and Lawrence A. Hunter, *The U.S. Anti-Savings Directive,* 2002 TNT 247-28.

[135] Section 871(h)(3).

[136] Section 881(c)(3)(A).

[137] Section 881(c)(3)(C).

[138] See JCX 40-99. This rate is however, negotiable, (*e.g.*, with Mexico the rate for interest is 4.9%; with Japan the rate for royalty is 10%).

[139] Id.

suggests higher rates for passive income in general, and for interest in particular, but leaves more tax revenues in the source country, but it is on a case-by-case basis.[140]

3. Taxation of Dividends and Total Return Swaps

As set forth above, the source of dividend income is generally the residency of the payor in many countries including the United States.[141] To date, there is no parallel portfolio dividend exemption in the United States; [142] dividend income is generally subject to a 30 percent withholding tax, unless a treaty applies to reduce the rate.[143] In many treaties, the rate for dividend is split; source country taxes at a 5% rate for dividends to shareholders who own a high percentage of the shares and 15% for portfolio dividends.[144]

U.S. withholding tax on inbound transactions by foreign investors may be avoided by using various types of derivatives, because the source of income from derivatives is generally the residency of holder.[145] For example, withholding on dividends can be

[140] Id.
[141] Section 861(a)(2)(A).
[142] See Yaron Reich (1998); Merrill et. al. at 1389 ("The recent proliferation of free trade areas bolsters the argument for zero withholding on direct dividends. The full benefits of an integrated regional market require elimination of barriers to capital flows -- including withholding taxes -- as well as trade flows.").
[143] See JCX 40-99. See, e.g. OECD Model Treaty, Article 10.2 (the source country has the right to tax dividend income distributed by a corporation resident in the source country. The rate of tax is limited to 15% in the case of portfolio dividends and 5% in the case of dividends paid to direct corporate investors).
[144] Id. See also U.S. Model Treaty, Article 10. Nevertheless, the shareholding threshold differs between the two models – while in the U.S. Model Treaty, the reduced rate would apply for 10 percent or more holding, the OECD Model Treaty requires at least 25 percent of shareholding to be eligible for the reduced rate.
[145] See, Thuronyi (2001) (describing various abusive situations); Reich (1998), citing the preamble to prop. Treas. reg. section 1.864(b)-1, issued June 11, 1998; Preamble to Regulations Issued under Section 446(b), T.D. 849, 58 Fed. Reg. 53125 (Oct. 14, 1993) ("[T]he IRS is considering whether notional principal contracts involving certain specified indices (e.g., one issuer's stock) should be excluded from the general sourcing rules of Section 861 through 865..."); Preamble to Proposed Regulations Regarding Certain Payments Made Pursuant to a Securities Lending Transaction, 1992-1 CB 1196 ("The Service is considering whether the proposed regulations should apply to dividend equivalent payments made in

avoided by using a total return equity swap; instead of buying the shares directly, the foreign investor enters into a swap with a U.S. investment bank and pays the value of the shares to the bank.[146] In return, the investment bank will pay to the foreign investor an amount equal to the dividend paid by the U.S. corporation ("the dividend equivalent amount"). There is no U.S. withholding tax on the payment of the dividend equivalent amount from the U.S. bank to the foreign investor, because the source rule of derivatives is the residence of the recipient. On the other hand, the dividends paid to the US bank are taxable to the US investment bank, but the bank may deduct the payment of the dividend equivalent amount as an expense, and thus the net income is 0. At the end of the contract, the bank will return the initial investment adjusted for changes in the price of the shares of the US corporation.[147]

In my view, there is no reason to distinguish between portfolio interest and dividend – both should be exempt if the above conditions for portfolio holding are met.[148] According to Reich (1998), there are two main reasons for enacting portfolio dividend exemption:

> A portfolio dividends exemption would align the U.S. tax treatment of dividend income of portfolio investors with the exemption that applies to all other portfolio investment income from stocks, securities, and related derivatives, thereby further fostering the open capital markets that are a

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connection with certain notional principal contracts, such as an equity index swap structured to replicate the cash flows that would arise from an installment purchase of one or more equity securities").

[146] Id. See also Avi Yonah (1996).

[147] Id.

[148] See Reich (1998) (elaborating that "the withholding tax on dividends paid to foreign investors may serve as a significant barrier to certain types of investments by foreign investors in U.S. equities.").

> featured and hallowed goal of U.S. international economic policy. . .A portfolio dividends exemption also would resolve the problem of how to deal with the disparity in treatment between dividends and returns on derivatives-based investments in U.S. stocks.[149]

The same arguments could be made in the case of developing countries. Thus, my suggestion to Country D would be to have the same exemption for interest and dividends earned by non-resident, as long as it satisfies the portfolio investment standard. Similarly, tax treaties should not have different rates for interest and dividend income.[150]

4. Capital Gains

In the United States as well as many other countries, the source of capital gains (other than from sale of inventory) is the residency of the seller (*i.e.*, formal rule).[151] The most common exception is for sales of real property - the source of capital gain on sale of real estate is the place of the real estate (economic rule).[152] Thus, capital gain on the sale of shares in a U.S. corporation by a foreign shareholder or sales of other securities (including derivatives) is not U.S. source income.[153]

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[149] Id.
[150] See, generally, Merrill et. al. at 1389.
[151] Section 865(a). In the case of inventory, there is a split between formal and economic rules. For purchased inventory, the source of income is the place of passage of title. It was designed to be an economic rule, but now it is considered a formal rule because "passage of title" is purely a formal element the parties may decide on. For produced inventory, there is a formula: 50% place of production and 50% place of sale (more economic rule). For intangibles, the source is the place of passage of title.
[152] Sections 861(a)(5) and 862(a)(5).
[153] See Reich (1998) ("Non-ECI capital gains recognized by foreign investors from the sale of U.S. portfolio securities (including gains on options, futures, and forward contracts) are generally exempt from U.S. income and withholding tax.").

Nevertheless, this treatment creates a potential unwarranted inconsistency between capital gains on sale of stock and dividends on the same stock, because the amount of gain from a sale of stock is essentially equal to the company's current accumulated earnings plus the present value of its future earnings- both represent earnings that if distributed, would give rise to dividend income sourced according to the residence of the payor. Thus, if a U.S. corporation distributes a dividend to its foreign shareholder, the income is U.S. source income. Nevertheless, if the corporation never distributes dividends and the shareholder sells the shares for a gain, it is foreign source income even though the gain represents the same value that would have been received as dividends.

5. The "Race to the Bottom"

The result of the United States' enactment of the portfolio interest exemption in 1984 has been a classic "race to the bottom" because many other countries have followed the United States and abolished their withholding tax on interest and dividends for fear of losing mobile capital flows to the United States.[154]

As further elaborated by Graetz and Grinberg (1997), many countries give up their rights to tax interest income derived by non-residents:

[154] Avi Yonah (2000). See also Edwards and de Rugy (2002) at 72, citing Sven-Olaf Lodin, "International Tax Issues in a Rapidly Changing World," International Bureau of Fiscal Documentation Bulletin, January 2001, p. 6. The authors indicate that "One survey of 19 major economies found that the withholding tax on bank interest has been more than cut in half in the past decade." Citing from Harry Huizinga and Gaetan Nicodeme, "Are International Deposits Tax-Driven?" European Commission Economic Paper No. 152, July 2001, p. 31-2.

Most corporate tax rates in OECD countries today are in the range from 25% to 35%. By imposing these corporate income taxes, source countries exercise their right to tax international business income. On the other hand, source countries today rarely exercise any right to tax interest income earned by foreign portfolio lenders and, where bilateral treaties are in force, tend to tax portfolio dividend income at a zero to 15% withholding rate.[155]

Table 1 shows how major developed countries tax income from interest dividends derived by non-residents.[156]

Table 1

Country	***Interest (w/h)***	***Dividends (w/h)***
Belgium	15%[157] - 25%	0%- 15% – 25%
Denmark	0%[158] - 30%	0%[159] - 28% -
France	16%	25%
Germany	0%[160] - 35%	0%
Greece	10% - 29%[161]	0%
Ireland	20%	20% - 0%[162]
Italy	0%[163] - 12.5% - 27%	0% - 12.5%[164]- 27%[165]

[155] Graetz and Grinberg (1997) at 548-9. See also Norregaard, John *Tax Treatment of Government Bonds*, 15 Tax Notes Int'l 143 ("The increase in international mobility of capital has led to significant downward pressures on these withholding rates, and has led a number of countries to abolish them since the mid-1980s.").
[156] These numbers are taken from Ernst & Young's Corporate Tax Guide (2006).
[157] Belgian source interest is subject to a 15% withholding tax if the underlying agreement was concluded on or after 1 March 1990.
[158] When certain conditions are met.
[159] Dividends are exempt from withholding tax if certain conditions are met.
[160] 35% withholding on over- the-counter transactions.
[161] This withholding tax applies to interest paid to foreign legal entities that do not have a permanent establishment in Greece.
[162] Exemption for non-residents if certain conditions are met.

Luxembourg	0%	20%
Netherlands	0%	25%
Portugal	15% - 20%	15%[166] - 25%[167]
Spain	15%	15%
United Kingdom	20%	0%
United States	0%[168] - 30%	30%
Japan	15% - 20%	20%
Australia	10%	0% - 30%
New Zeeland	15%[169] - 19.5%[170]	30%[171] - 33%[172]
Canada	25%	25%
Russia	15%-20%	9% - 15%[173]
Brazil	15%	0%
Mexico	10% - 29%	0%
Argentina	15.05% - 35%	0%
Singapore	15%	0%
Hong Kong	0%	0%
Philippines	20% - 35%	0% - 15% - 35%
Norway	0%	25%
Sweden	0%	30%
Switzerland	35%	35%

These low rates of tax on interest and dividend income by the source countries are consistent with the vast majority of tax treaties.[174] As set forth above, all three tax treaty models advocate lower rates for passive income (between 0 to 15 percent), and in many

[163] Interest derived by nonresidents on deposit accounts.
[164] Dividends paid to resident individuals with non-substantial participation.
[165] Dividends paid to non-residents.
[166] Paid to residents.
[167] Paid to non-residents.
[168] Portfolio interest is exempt.
[169] Withholding tax for non-residents.
[170] Withholding tax for residents (individuals).
[171] Withholding tax for non-residents.
[172] Withholding tax for residents.
[173] The 15% rate applies if either the payor or the recipient of the dividend is a foreign legal entity
[174] Interest is defined under Article 11 of both the OECD Model Treaty and the U.S. Model Treaty as "income from debt-claims of every kind."

cases, the rate on interest income is reduced to zero.[175] In general, most treaties reduce the rates on income from interest and dividends to no more than 15% and therefore, allow the residency country to collect most of the tax on such income.[176] Furthermore, most treaties provide that capital gains tax is collected by the residency country.[177] Thus, when countries adopt portfolio interest exemption provisions similar to the US, they simply conform their internal tax laws to what a treaty would normally mandate for such income.

Table 2 shows how the above countries tax income from interest dividends derived by non-residents under treaties.[178]

<u>Table 2</u>

Country	***Interest (w/h)***	***Dividends (w/h)***
Belgium	5% - 25%	10% - 20%
Denmark	0%	0% - 25%
France	0% - 20%	0% - 25%
Germany	0% - 25%	0% - 20%
Greece	0% - 40%	-
Ireland	0% - 15%	0%
Italy	0% - 27%	0% - 27%
Luxembourg	0%	0% - 20%
Netherlands	0%	0% - 20%
Portugal	10% - 15%	10% - 15%
Spain	0% - 15%	0% - 15%
United Kingdom	0% - 25%	-
United States	0% - 30%	0% - 30%
Japan	0% - 20%	0% - 20%

[175] Id. ("interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State… However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State. . . .").
[176] Id. See OECD Model Treaty (suggests rates of 5% to 15% on dividends, 10% on interest, and 0% on royalties; U.S. Model Treaty (suggests rates of 5% to 15% on dividends, and 0% on interest and royalties).
[177] Id. Article 13.
[178] These numbers are taken from Ernst & Young's Corporate Tax Guide (2006).

Australia	10%-12%	15% - 25%
New Zealand	10% - 15%	15%
Canada	0% - 25%	0% - 25%
Russia	0% - 15%	5% - 15%
Brazil	12.5% - 15%	0%
Mexico	4.9% - 15%	0% - 15%
Argentina	0% - 20%	10% - 15%
Singapore	0% - 15%	-
Hong Kong		
Philippines	10% - 15%	15% - 25%
Norway	-	0% - 25%
Sweden	-	0% - 25%
Switzerland	0% - 15%	0% - 15%

The enactment of the portfolio interest exemption clearly achieved its goal in the United States.[179] Developing countries have even more incentive to follow these rules. [180] As two commentators indicate:

> High tax rates are more difficult to sustain in the new economic environment. That is particularly true for taxes on capital, which include taxes on business profits and taxes on individual receipts of dividends, interest, and capital gains. Basic economic theory suggests that high taxes on capital create an increasing drag on growth as capital mobility increases. High taxation of capital causes capital flight, thus reducing

[179] Dan R. Mastromarco and Lawrence A. Hunter, *The U.S. Anti-Savings Directive,* 2002 TNT 247-28 ("For nearly two decades, U.S. law has encouraged foreigners to invest in U.S. banks and debt securities by imposing no tax on interest earned on foreign deposits, except in very narrow circumstances. The policy is estimated to have attracted approximately $ 1 trillion to the United States. Reversing this policy risks driving hundreds of billions of dollars out of the United States.").

[180] See Avi Yonah (2000) at 1582 ("The standard economic advice to small, open economies is to avoid taxing capital income at its source, because the tax will be shifted forward to the borrowers and result in higher domestic interest rates.").

domestic productivity, wages, and incomes.[181]

Thus, when the source country attempts to impose tax on interest, for example, the return for the foreign investor will be reduced by virtue of the withholding tax, and this will create a disincentive by the investors to invest in Country D.[182] This is particularly true for small open economies such as Country D, which generally accept world interest rates as a given.[183]

Furthermore, as set forth above, residency-based taxation promotes CEN, and with respect to passive income, it is even clearer.[184] Taxation of portfolio investment by residency countries has been viewed by many commentators as the most efficient regime:

> From the point of view of worldwide efficiency, there would seem to be no reason for tax rules to distort the decisions of portfolio investors. If a

[181] See Edwards and de Rugy (2002) (The authors quote from the 1991 OECD Report: "A domestic corporate tax increase will therefore tend to cause an outflow of corporate capital, and in the long run, the resulting shortage of capital in the domestic economy will drive up the pre-tax rate of return to wage earners, because the lower capital intensity of domestic production will reduce labour productivity and real wage rates. Part of the burden may also fall on owners of immobile factors of production such as falling land rents and land prices." Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy (Paris: OECD, 1991), p. 34).

[182] Leif Muten *International Experience of How Taxes Influence the Movement of Private Capital,* 8 Tax Notes Int'l 743, 744 (1994) ("If the goal is to facilitate foreign financing of domestic enterprises, and to keep foreign borrowing by government from looking too expensive, there is some appeal to leaving interest payments to foreign residents outside the tax system. Assuming full shifting to the debtors, foreign borrowing will not be made more expensive by such a policy, i.e., from the point of view of the national economy.").

[183] Id. See also Avi Yonah (2000) at 1582.

[184] See Avi Yonah (2000) at 1605, quoting Assaf Razin & Efraim Sadka, *International Tax Competition and Gains from Tax Harmonization*, 37 Econ. Letters 69, 69-70 (1991) ("If a country adopts the residence principle, taxing at the same rate capital income from all sources, then the gross return accruing to an individual in that country must be the same, regardless of which country is the source of that return. Thus, the marginal product of capital in that country will be equal to the world return to capital. If all countries adopt the residence principle, then capital income taxation does not disturb the equality of the marginal product of capital across countries which is generated by a free movement of capital.").

> foreign equity or debt investment offers an investor a higher rate of return than a domestic one, it is reasonable to conclude that the money can best be used abroad. Thus, the best tax regime would seem to be one that taxed investors the same whether they choose the foreign or domestic security. In short, the CEN approach can be resuscitated as a solid basis for taxation of income from portfolio investments.[185]

Nevertheless, while normally, the interest income will be taxed in residency country, it could be avoided by establishing a company in a tax heaven (which does not have withholding on interest paid). It is also possible that the residency country will not have adequate resources to enforce its rights to tax the income that was forgiven by the source country.[186] Thus, Professor Avi Yonah has been concerned that portfolio income that is not taxed by the source country would not be taxed by the residency country either.[187] In this case, he points out, CEN will be violated because "the investor would prefer to invest in the host country rather than in the home country, even if the pretax yield on the domestic investment were higher."[188]

I share the same concern; residency countries must make all the necessary effort to exercise their taxing rights and make sure that the interest or dividend income is taxed. Thus, in order to achieve CEN and promote economic growth in Country D, residency

[185] Frisch (1990) at 587.
[186] See generally Avi Yonah (2000).
[187] Id. at 1583-4 (quoting Joel Slemrod "although it is not desirable to tax capital on a source basis, it is not administratively feasible to tax capital on a residence basis…" See also id at 1585 ("in the absence of withholding taxes or effective information exchange, income from foreign portfolio investments frequently escapes being taxed by any jurisdiction.").
[188] Id. at 1604.

countries should enforce their rights to collect the tax on portfolio investments made in other countries.[189] This will require exchange of information among countries.[190] As discussed immediately below, the European Union has adopted a Directive pursuant to which interest earned by a taxpayer from one member state in another member state will be taxed by the latter state, provided that countries will share all the necessary information.[191] In addition, the OECD has recently revised Article 26 in the OECD Model Treaty to require more exchange of information. These measurements are expected to increase the flow of information between countries and ensure that more income is taxed by residency countries.

6. The EU Savings Directive

Council Directive 2003/48/EC on taxation of savings income in the form of interest payments was issued on June 3, 2003. The purpose of the Savings Directive was:

> to enable savings income, in the form of interest payments made in one Member State to "beneficial owners"[footnote omitted] who are individual residents for tax purposes in another Member State, to be made subject to effective taxation in accordance with the laws of the latter Member State.

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[189] See Graetz and Grinberg (1997), at 586 ("The key difficulty for residence-based taxation of international portfolio income results from the widespread underreporting and evasion that now occurs. Any solution to that problem necessarily will require both unilateral and multilateral actions. The good news is that the United States has already taken a major step forward in its information reporting requirements for qualified financial intermediaries, and recent actions in both the OECD and the EU offer promise of vastly improved multinational cooperation. The advent of new financial innovations and the persistence of financial tax havens and bank secrecy ensure, however, that there will be many opportunities for improvement for years to come.").

[190] See, generally, Cynthia Blum, *Sharing Bank Deposit Information with other Countries: Should Tax Compliance or Privacy Claims Prevail?*,2005 TNT 44-28.

[191] See "Council Directive 2003/48/EC on taxation of savings income in the form of interest payments" (Hereinafter "Savings Directive").

The scope of the Savings Directive is limited to taxation of savings income in the form of interest payments on debt instruments. In my view, the most important element of the Savings Directive was to establish a structured mechanism for exchange of information:

> Where the beneficial owner is resident in a Member State other than that in which the paying agent is established, the Directive stipulates that the latter must report to the competent authority of its Member State of establishment a minimum amount of information, such as the identity and residence of the beneficial owner, the name and address of the paying agent, the account number of the beneficial owner or, where there is none, identification of the debt claim giving rise to the interest, and information concerning the interest payment.

The Savings Directive illustrates that the principle established by the League of Nations Report (1923) pursuant to which passive income should be taxed by the residency country is still in full force. What the Savings Directive also illustrates is that applying residency-based taxation for income from financial transaction must go hand-in-hand with comprehensive exchange of information guidance.

Similarly, the OECD has recently modified Article 26 (Exchange of Information) of the OECD Model Treaty and has adopted a Model Tax Information Exchange Agreement, both of which address the issue of exchange of information. Under both agreements, exchange of information is mandatory rather than elective and overrides bank secrecy provisions in domestic laws.[192]

7. Conclusions

In general terms, foreign investors in Country D will not be taxed on interest and dividends received from domestic payors, thereby leaving the tax jurisdiction for such income to the investor's residency country. As set forth in greater detail below, such a regime would not constitute a harmful tax competition;[193] exempting foreign portfolio investment from tax in Country D would simply make Country D's tax regime similar to other tax regimes in developed and developing countries.

This treatment would also be consistent with the relevant provisions in the majority of income tax treaties.[194] Thus, whether Country D had an income tax treaty with the foreign investor's residency country or not would not matter since in either case, the residency country will collect the tax.

C. Taxation of Derivative Transactions[195]

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[192] See *Prepared Testimony of Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law, University of Michigan Law School Before the US Senate Permanent Subcommittee on Investigations, Hearing on Offshore Transactions* (Aug. 01, 2006), published in 2006 TNT 148-42.

[193] For a seminal article on tax competition, see Charles Tiebout, "A Pure Theory of Local Expenditures," Journal of Political Economy, October 1956, pp. 416-24. See also OECD, Harmful Tax Competition: An Emerging Global Issue (Paris: OECD, April 1998), at 14 (defining harmful tax competition as "free riding" that "may hamper the application of progressive tax rates and the achievement of redistributive goals.").

[194] Ault (1992) at 571 ("the treaty structure has been developed explicitly to allocate taxing claims with respect to international income.").

[195] For an excellent overview of what are derivatives, who uses them, for what purposes, and how are they taxed (and how should derivatives be taxed), see May (1995) and Rosenbloom (1996), both of which were written in connection with the IFA Report (1995). An in-depth discussion on these issues is beyond the scope of this article.

a. Overview

A derivative instrument is a "contract between two parties that specifies conditions – in particular, dates and the resulting values of the underlying variables – under which payments, or payoffs, are to be made between the parties." [196] Derivative instruments generally include options, forwards, futures and notional principal contracts.[197] According to Rosenbloom (1996), to some extent, a derivative instrument resembles an insurance contract because it is "a device used to shift risk from one party to another."[198]

Options: An option is an agreement pursuant to which the buyer of the option has the right but not the obligation to buy from, or to sell to, the seller, a pre-specified number of units of underlying asset, for a pre-specified price (strike price) at, or before a specified date in the future (expiration date).[199]

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[196] Rubinstein, *Rubinstein on Derivatives* Sec. 1 (1999).
[197] See Plambeck, Rosenbloom & Ring, *General Report*, in 85*b Cahiers De Droit Fiscal International*, 660-661 (Kluwer 1995) ("In general, financial instruments are contractually created rights and obligations to transfer specified amounts of money at specified points in time. The terms of the payments express the risks and rewards accepted by each of the parties to the contract. A derivative financial instrument is one under which the payment rights and obligations of the parties (and therefore the value of the contract) derive from the value of an underlying cash or physical market (e.g., foreign exchange, securities, commodities) or from particular indices or combinations of indices.").
[198] Rosenbloom (1996) at 597.
[199] See *Federal Home Loan Mortgage Corporation v. Commissioner*, 125 T.C. No. 12 (2005) (The Tax Court provided an excellent overview on the economics of option contracts). A Call option is a contract that allows the holder to buy a specified quantity of stock from the writer of the contract at a fixed price for a given period. Thus, if the market value of such stock were to fall below the price specified in the option contract, the holder normally would not exercise the option and would allow it to lapse. On the other hand, if the market value of the underlying stock were to rise above the price specified in the option contract, the holder probably would exercise the option before it lapses. A put option is a contract that allows the holder to sell a specified quantity of stock to the writer of the contract at a fixed price during a given period. Thus, if the market value of the stock that is the subject of the option were to rise above the price specified in the option contract, the holder of the put normally would not exercise the option and would allow it to lapse. On the other hand, if the market value of the underlying stock were to fall below the price specified in the option contract, the holder most likely would exercise the put before it lapses.

An option is defined for U.S. tax purposes as a contract pursuant to which the writer of the option undertakes an obligation to sell to the option holder, or purchase from the holder, specific property at a fixed or determinable price and time.[200] Generally, options, like forward contracts, are also treated as open transactions for United States tax purposes.[201]

Example of a call option: A holder of the call option pays $10 to the writer of the option for the right to purchase IBM stock at $100 from the writer.

Example of a put option: A holder of a put option pays $10 to the writer for the right to sell IBM stock at $100 to the writer.

Forward Contracts: A forward contract is an agreement pursuant to which the buyer agrees to buy from the seller an underlying asset for a fixed price (delivery price) on a single specified date in the future (delivery date), where the terms are initially set so that the present value of such a contract is zero.[202] "The key difference between [options and forward contracts] is that the holder of an option has a right, for which it has generally paid a fee or premium, but no obligation. In contrast, the forward creates mutual obligations and mutual rights and, since either party may gain as a result of the contract,

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[200] Rev. Rul. 78-182, 1978-1 C.B. See also Avi Yonah and Swartz (1997); May (1995).
[201] Id. Section 1234(b) governs the treatment for the grantor of options in property, which means options on stock, securities, commodities, and commodities futures, provided the option is not otherwise subject to section 1256 as described above. For a grantor of an option in property (see below), gain or loss is not recognized until the option lapses or expires, is exercised or closed. Id. The premium received is recognized when such sale, exchange, expiration, or closing (offsetting) transaction occurs. When the option is exercised, this event is, generally, treated as a non-taxable purchase of the underlying asset by a holder of a call or grantor of a put, but as a taxable sale by the other party to the option.
[202] See M. Rubinstein, *Rubinstein on Derivatives* (1999), Sec. 2.2.

it is common that no funds, or premiums, change hands at the inception of the contract."[203]

A forward contract is defined for U.S. tax purposes as *a privately negotiated contract that provides for the sale and purchase of property for a specified price on a specified date*.[204] For U.S. tax purposes, until the forward contract is sold, exchanged, settled or allowed to lapse, the transaction is treated as open, and any gain or loss to the parties is deferred.[205] Upon the delivery, gain or loss on a forward contract is capital to the extent the asset underlying the forward contract would be a capital asset in the taxpayer's hands.[206]

Example of a forward contract: A contract entered into on January 1, 2004 between a buyer and seller, pursuant to which the seller will sell the buyer 1,000 shares of IBM stock for $100, on September 1, 2004.

Futures Contracts: Futures contracts are similar to forward contracts except that they are: standardized; traded at regulated futures exchanges; used by clearing organizations;

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[203] Rosenbloom (1996) at 599.
[204] *Glass v. Comm'r,* 87 T.C. 1087, 1101 (1986).
[205] See David S. Miller, *Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects*, 51 Tax Lawyer 279, 305 (footnotes 101-104 and accompanying text). In contrast, in the United Kingdom, derivatives "are taxed on income account in the amounts recognized for accounting purposes, provided that the accounts use either an accruals or mark-to-market method." See Robert Moncrieff , *Next Steps for Debt and Derivatives: The U.K. Finance Act 2002*, 4(1) Journal of Taxation of Financial Products (2003).
[206] See May (1995) (explaining that "That result seems relatively unsurprising in the case of a forward. No cash passes until the performance date, and the seller does not become entitled to anything until the contract period has elapsed.").

subject to daily mark-to-market system; and can be closed before maturity.[207] Futures contracts are subject to mark-to-market treatment in the U.S. pursuant to section 1256.[208]

Notional Principal Contracts: A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[209] Notional principal contracts include interest rate swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, and similar agreements.[210]

A swap is a contract pursuant to which the parties agree to exchange payments calculated by reference to a notional amount.[211] Examples include interest rate swaps, foreign currency swaps and equity swaps.

<u>Example of an interest rate swap</u>: Notional amount is $1,000. Party A pays party B an amount equal to 5% of the notional amount every year, and party B will pay A an amount equal to LIBOR times the notional amount. The amounts from each party are netted.

In the United States, the notional principal contracts regulations group all payments under notional principal contracts into three categories: (i) periodic payments; (ii) non-periodic

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[207] Avi Yonah and Swartz (1997).
[208] Id. See also May (1995).
[209] Regs. § 1.446-3(c)(1)(i).

[210] Section 1256 contracts, debt instruments, options and forward contracts do not constitute notional principal contracts. Regs. § 1.446-3(c)(1)(ii).
[211] See Avi Yonah and Swartz (1997).

payments; and (iii) termination payments.[212] A party to a notional principal contract must annually include in gross income any "net income" from the contract or is allowed to deduct any net cost.[213]

All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment and a non-periodic payment for the taxable year to which such portions relate.[214] A non- periodic payment must be amortized and recognized over the contract term in a manner that reflects the economic substance of the contract.[215] A termination payment is recognized by the original party to the contract as income or deduction when the contract is extinguished, assigned, or exchanged.[216]

b. Risk Management and Hedging

Businesses routinely use hedging transactions to manage risks related to movements in commodities and securities prices, currencies, and interest rates.[217] Instruments available to manage such risks include options, futures and forward contracts, and notional principal contracts.[218] Businesses can hedge assets or liabilities, and can also hedge these exposures only in part or only for a limited time.[219]

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[212] May (1995).
[213] Id. see also Regs. § 1.446-3(d).
[214] Regs. § 1.446-3(e)(2)(i) and 1.446-3(f)(2)(i).
[215] Id.
[216] Regs. § 1.446-3(h)(2).
[217] See, generally, David C. Garlock, *Federal Income Taxation of Debt Instruments*, Chapter 17.01[A] (2005 Ed).
[218] Id.
[219] See Avi Yonah and Swartz (1997).

As set forth above, Rosenbloom (1996) observed that:

> A derivative usually insures against a financial risk, such as the chance that a particular currency will rise or fall in value, that the price of a commodity such as corn will rise above or fall below a particular level, or that interest rates will move in a particular direction.[220]

Most countries do not have specific rules for hedging transactions. In the United States, prior to 1993, the tax treatment of hedging transactions was entirely a matter of case law and administrative practice.[221] In 1988, the Supreme Court in *Arkansas Best Corp. v. Comm'r* held that gain or loss on the sale or exchange of an asset is capital unless the asset falls within one of the specifically enumerated exceptions in section 1221.[222] In *Fannie Mae v. Comm'r*, the IRS argued that *Arkansas Best* required the taxpayer to treat its hedging losses as capital, but the Tax Court disagreed and held for the taxpayer.[223] In 1993, the IRS issued temporary regulations governing hedging transactions, followed by final regulations in 1994.

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[220] Rosenbloom (1996) at 598 (Illustrating with the following example: "The holder of an option to purchase 100,000 Deutsche marks at 1.3 DM to the dollar is not required to demand payment, and presumably will not do so unless the event insured against - the risk - occurs (for instance, the Deutsche mark rises to 1.1:1). If that occurs, the holder of the option has an economic incentive to require the option writer to sell Deutsche marks at the option price of 1.3 DM to the dollar to the extent specified in the option contract. The holder's gain upon the exercise of the option will precisely mirror the risk that 100,000 Deutsche marks would rise above the designated level.").

[221] See *Corn Products v. Commissioner,* 350 U.S. 46 (1955).

[222] *Arkansas Best v. Commissioner,* 485 U.S. 212 (1988).

[223] *Federal Nat'l Mortgage Ass'n v. Commissioner*, 100 T.C. 541 (1993).

Pursuant to section 1221(b)(2), "[t[he term 'hedging transaction' means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks as the Secretary may prescribe in regulations."[224]

<u>Example of hedging prices of commodities</u>: Corporation X is a corn processor that uses grain corn to manufacture products such as corn starch. On July 1, X enters into a contract to deliver to a customer a fixed quantity of starch at a fixed price in October. Because of limited storage space, X will not purchase the corn needed to fulfill the starch contract until September. If the market price of corn increases between July and September, X's profit on the starch contract would be reduced or eliminated.[225] To protect itself against such risk, X enters into a long futures contract on corn (*e.g.*, a contract to buy corn). In September, X will buy and take physical delivery of the corn needed to fulfill the starch contract, and at the same time settle the futures contract by

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[224] Section 1221(b)(2). May (1995) elaborates that "The definition [of hedging transaction] contains several key requirements. First, the taxpayer must identify the relevant contract or other position as a hedge. Second, the hedged item must be an ordinary, rather than a capital, asset or obligation. Third, changes in the value of the hedge must offset changes in the value of the hedged item. Finally, after taking into account the taxpayer's other positions, the hedge must reduce the taxpayer's overall exposure to the relevant risk."

[225] See Garlock (2005) at 17.01[A].

either making or receiving a termination payment f cash. The amount paid or received to terminate the futures contract will offset a decrease or increase in X's cost of corn, and thus profit on the starch contract. The result is that X has effectively locked in the future purchase price of the corn needed to fulfill the customer order, and X's profit will not be affected by changes in the price of corn.[226]

Example of hedge of a debt liability (interest rate risk): An issuer (party A) of $1,000 debt paying LIBOR wishes to hedge against the risk that LIBOR will increase (*i.e.,* increases the issuer's costs). To manage such risk, the issuer enters into an interest rate swap with party B pursuant to which A will pay B 5% fixed on a notional amount of $1,000, while B will pay LIBOR on the same notional amount. The result is that A's borrowing costs are now fixed at 5%.[227]

In general, hedging transactions are awarded a special treatment in the United States.[228] The rationale is clear – hedging transaction should be encouraged, since risk management is a crucial element in the economy.[229] As discussed in greater detail below, taxation of income from cross-border derivatives that serve as hedging transaction could have a

[226] Id.
[227] Id.
[228] See generally Treas. Reg. §1.1221-2 (Matching ordinary gains with ordinary losses on the hedging transaction and the hedged item) and Treas. Reg. §1.446-4 (Matching hedging gains and losses to gains and losses on hedged items).
[229] See Conference Report for the Omnibus Budget Reconciliation Act of 1993, H.R. Rep. No. 213, 103d Cong., 1st Sess. 616 (1993) (emphasized the importance of hedging transactions to the United States economy). See also *Thuronyi* (2001) at 264.

significant impact on the ability of domestic businesses to manage their risk of doing business.[230]

c. *Cross-border Aspects of Derivatives*

As opposed to the portfolio investment issue discussed above, there is more "international consensus" concerning taxation of cross-border derivatives.[231] The forty-ninth Congress of the International Fiscal Association ("IFA") focused upon tax aspects of derivative financial instruments and issued its recommendations to deal with cross-border aspects of derivatives.[232] The IFA Report (1995) set forth that the international consensus for taxation of cross-border derivatives is that the source country generally does not impose tax earned by non-resident on income from derivatives.[233]

Nevertheless, before addressing the cross-border aspects of income from derivatives, the jurisdiction must establish basic timing and character principles for taxation of derivatives in general:

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230 See e.g., David Garlock, Yoram Keinan, Howard Leventhal, and Alan Munro, *Proposals Regarding the Taxation of Credit Default Swaps,* 18 J. Tax'n F. Inst. 5 (2005) (advocating residency-based taxation for credit default swaps).

231 See Rosenbloom (1996) at 602-3, citing the IFA Report (1995) at 684-6. See also Thuronyi (2001) at 270 (agreeing that such a consensus exists but providing two examples of countries (Mexico and Greece) that withhold on income from derivatives under their domestic laws).

232 See generally IFA Report (1995). See also Rosenbloom (1996) at 602-3 ("the only 'pure' international issue raised by such instruments pertains to taxation in the country of source on a gross basis. It is here that close analysis of the special features of derivatives is required, and here, if anywhere, that derivatives place pressure on the international rules. The question posed is whether the country from which payment is made under a derivative financial instrument should have the right to impose tax on that payment.").

233 See IFA Report (1995) at 684-6; Rosenbloom (1996) at 603.

> The promulgation of a single, consistent set of rules to tax derivative transactions is a daunting task that must be approached on two levels. Such a system first must be crafted to reach fair and consistent results with regard to the use of derivative products among U.S. parties. Assuming this goal could be achieved, the resulting rules also must be designed to produce the same consistent results with respect to cross-border derivative transactions.[234]

Absent tax considerations, local businesses typically would be indifferent between entering into a derivative with a domestic or foreign counterparty — price is the dominant consideration.[235] However, if a payment to or from a foreign counterparty were subject to withholding tax in Country D, that consideration undoubtedly would outweigh any price differential, so the effect of a withholding tax would be simply to eliminate foreign counterparties from the domestic market — an unwarranted result, in my view.[236]

In the case of developing countries, the vast majority of derivative transactions will be between local businesses and foreign counterparties because the local derivative markets are probably undeveloped.[237] Thus, participation of foreign parties in the domestic market

[234] Avi Yonah and Swartz (1997), citing the IFA Report (1995). See also Rosenbloom (1996) at 601 ("The subject of derivative financial instruments is international to a limited extent. The most pressing tax issues pertaining to derivatives are basic and thus domestic: What is to be taxed, and when? What character does the resulting income or loss have? These are largely domestic matters, in the sense that they apply to transactions between resident taxpayers in a given jurisdiction.").
[235] In general, foreign counterparties would provide domestic businesses with better prices than domestic counterparties.
[236] See generally, IFA Report (1995). See also Thuronyi at 271 (2001) ("The result will be that the withholding tax will, in effect, preclude domestic taxpayers from entering into derivative agreements with taxpayers resident in non-treaty partners…").
[237] Thuronyi (2001) at 264.

is essential not only because it increases the liquidity in the market, but also because it provides access to derivatives to more domestic businesses by virtue of providing more choices and better prices.[238]

Another consideration relevant to foreign counterparties is whether entering into a derivative transaction with domestic counterparties could be construed as the conduct of a trade or business in Country D.[239] This too could have the practical effect of barring foreign counterparties from the domestic derivative market in Country D. This issue is discussed below in the next chapter.

In general, the United States uses "a residence- based sourcing rule to waive source-based claims on the derivative instrument income of nonresident foreign persons."[240] Thus, unless the gain on a derivative is connected with a U.S. trade or business or U.S. real estate, it is not U.S.-source income.[241] As set forth above, the definition of FDAP income in the U.S. is very broad and includes various types of income.[242] The income need not even be annual or periodical, so a single payment could also constitute FDAP.[243] Nevertheless, certain specific exceptions exist, one of which is for gains from the sale of property, including option premiums.[244]

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[238] Id. at 271.
[239] See Prop. Reg. 1.864(b)-1.
[240] See May (1995).
[241] Id. See also See Charles T. Plambeck et al., General Report [hereinafter General Report] in 80b Cahiers de Droit Fiscal International 653 (1995). A Similar approach is applied in the United Kingdom. See Moncrieff (2003) ("Payments made in respect of derivative contracts have traditionally fallen outside withholding tax requirements and this has been confirmed in the 2002 rules.").
[242] Reg. § 1.1441-2(b)(1)(i).
[243] Reg. § 1.1441-2(b)(1)(ii).
[244] Reg. § 1.1441-2(b)(2)(i).

There is no specific exception from FDAP income for payments under a notional principal contract; nevertheless, pursuant to Reg. § 1.863-7(b), if the foreign counterparty is not engaged in a U.S. trade or business, a payor of periodic payments under a notional principal contract is not required to withhold on its periodic payments to the foreign counterparty because the payment will be treated as having a foreign source.[245] The source of the periodic payments under a notional principal contract is the *residence of the recipient* of the income and not the residence of the payor.[246] While this looks like a formal source rule, according to David Hariton (on behalf of the New York State Bar Association Tax Section) the source of income from notional principal contracts contained in Reg. §1.863-7 is where the activities relating to the notional principal contract itself took place.[247] Other countries, however, have attempted to trace the risk being managed by derivatives; in Argentina and Columbia, for example, income from derivatives has domestic source if the undertaken risk is therein.[248]

[245] The definition of a notional principal contract under Reg. § 1.863-7(a) is the same as that under Reg. § 1.446-3(c). *See also* Reg. § 1.1441-4(a)(3), pursuant to which payments with respect to a notional principal contract described in Reg. § 1.863-7(a) are not subject to U.S. withholding tax. For an in-depth discussion on the cross-border aspects of financial instruments, *see* Avi-Yonah and Swartz (1997).

[246] Reg. § 1.863-7(a). See also Reg. 1.988-4(a) for foreign currency swaps. Special rules apply to payments on notional principal contracts that are classified as "embedded loans."

[247] See Hariton, David P. (on behalf of the New York State Bar Association Tax Section), *Credit Default Swaps*, 40 Tax Notes Int'l 545, at note 120 ("While Treas. Reg. section 1.863-7 is often thought of as providing a rule that notional principal contract payments to a foreign person are foreign source, that is not true if the payments constitute effectively connected income. In that case, the payment is treated as U.S.-source income. Treas. Reg. section 1.863-7(b)(3).")

[248] Teijeiro, Guillermo O. *Argentine Anti-Avoidance Rules: Application Under Domestic And International Conventional Law*, 32 Tax Notes Int'l 67 (Aug. 21, 2003), citing Argentina income tax law, First section (unnumbered) after sec. 7. "[R]isk is considered situated in Argentina whenever the party to the transaction obtaining the income is a resident in Argentina or a domestic permanent establishment of a foreign company." Id. See also Andrade, Mario*, A Tax Overview of Derivatives Transactions in Colombia*, 22 Tax Notes Int'l 3080 (June 1, 2001) ("If the transaction is cross-border between a resident and a nonresident, it must be determined where the coverage service is rendered. If the services are rendered by a Colombian resident, any payment abroad is considered as national-source income subject to Colombia's 35 percent corporate income tax, plus an additional 7 percent remittance tax, net of income tax, for a fixed 39.55 percent rate.").

As of today, there are no specific source rules in the United States for gains or losses on options, forward contracts and futures contract.[249] In addition, there are no source rules for income from other types of payments under a notional principal contract (*i.e.*, non-periodic and termination payments).[250] Thus, under the normal source rules for sales of property contained in section 865, the source of gain from such derivative contracts is similar to the source of capital gain.[251]

While the general consensus among countries is that income from cross-border derivatives is taxed by the residency country, several alternatives to reach such result have emerged.[252] In Canada, for example, a different approach but with similar result is applied.[253] In general, if a non-resident does not have trade or business in Canada, payments received by such non-resident under options, forward contracts or swaps are generally not subject to Canadian tax if none of these payments can reasonably be characterized as interest, dividend, or rental payments (which is normally the case).[254]

Similarly, in the United Kingdom:

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[249] See Avi Yonah and Swartz (1997). Section 865(j)(2) gave the IRS the authority to issue regulations pertaining to the source of income from forward contracts, but such regulations have yet to be issued. Id.

[250] Id.

[251] Id. See also May (1995) (explaining that "The income realized from forwards, futures, and options is gain. Unless the gain is connected with a U.S. business or U.S. real estate, [footnote omitted] it is not U.S.-source income because it takes its source from the recipient's foreign residence."); David F. Levy, *Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals For Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments*, 97 TNT 188-98 (September 25, 1997).

[252] See Rosenbloom (1996) at 603, citing the IFA Report (1995).

[253] See Bernstein, Jack, Jondahl, Sky and Nicholls, Andrew, *The Canadian Treatment of Derivatives*, 37 Tax Notes Int'l 587 (2005).

[254] Id.

> Payments made in respect of derivative contracts have traditionally fallen outside withholding tax requirements and this has been confirmed in the 2002 rules. However, although derivative payments themselves may not be subject to withholding tax, derivative contracts may include items such as interest payments that are currently, and that continue to be, subject to the withholding tax provisions.[255]

The source rules pertaining to notional principal contracts in the United States were first established by the IRS in 1987,[256] and shortly after were regulated under Reg. § 1.863-7. Although not stated formally, the reason behind the special rule was to permit cross-border notional principal contracts without the impediment of a withholding tax.[257] This principle is consistent, of course, with the recommendations in the IFA Report (1995) that is discussed below.

I can think of no reason why this policy should not apply equally to developing countries.[258] As stated above, the opposite policy would not result in the collection of any tax revenues; it would simply eliminate foreign persons as potential counterparties for derivative transactions. In general, derivatives are mainly used for hedging and speculation purposes.[259] With respect to hedging, it is generally accepted that risk

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[255] See Moncrieff (2003).
[256] *See* Rev. Rul. 87-5, 1987-1 C.B. 180. Two year before, the New York State Bar Tax Section issued a report that advocated no withholding tax on swap payments. See *New York State Bar Association Examines Whether Payments To Foreigner In Interest Rate Swap Agreement are Subject To Withholding*, 85 TNT 118-52.
[257] *See* Rosenbloom (1996); Thuronyi (2001)
[258] Id.
[259] Id. at 597-98 (1996) ("A derivative financial instrument is a device used to shift risk from one party to another. On this fundamental point, derivatives resemble insurance, a concept familiar to anyone who has

management is a crucial element in every business's growth.[260] Thus, Country D would clearly want to allow local businesses to manage their risk by entering into derivatives with foreign counterparties (assuming that the local banks could not satisfy this need).[261] Nevertheless, foreign counterparties will hesitate to enter into hedging transactions with businesses in Country D if income from such transactions will be subject to tax in the source country.

As set forth above, the IFA Report (1995) discussed the issue of cross-border derivatives and reached several resolutions to promote sensible, consistent worldwide taxation of derivatives.[262] The IFA Report (1995) first acknowledged that countries should recognize the importance of derivative transactions remove tax impediments to the use of derivative instruments.[263] In accordance with general tax policy principles, the IFA Report (1995) concluded that the tax rules for derivatives should be fair, simple, and

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purchased a vehicle or home. In an insurance transaction one party pays a fee, or premium, to another. In return, the other party undertakes the risk of paying the first party up to a specified amount in the event of a specified occurrence (such as a theft or fire). If the occurrence comes to pass, the first party has a claim against the second, which gives value to the insurance contract. That value depends on, or derives from, the occurrence, which is typically beyond the influence or control of either party, and the extent of the resulting loss. If the occurrence does not come to pass, the contract expires without having any value to the first party. Yet, such a transaction is sensible because, during the specified period, the insured was relieved of the risk of suffering loss as a result of the specified event by shifting the economic burden of that risk to the insurer.").

[260] Colon (1999) at 777 ("Financial instruments permit firms to transfer financial price risks to other investors better able or more willing to bear such risks. Financial instruments help firms to lower their financing costs and hedge more efficiently in both specific transactions, such as the purchase or sale of products in foreign currency, as well as in strategic cash flow hedging.").

[261] See Andrade, Mario*, A Tax Overview of Derivatives Transactions in Colombia*, 22 Tax Notes Int'l 3080 (June 1, 2001) ("Operations with derivatives have recently started to expand in Colombia. Normally, investors and economic agents choose those types of operations when market fluctuations make the return on an investment or the feasibility of a transaction riskier. Because of the volatility of some indexes of the region -- such as interest rates, the exchange rate, and the prices of basic products -- more national and foreign investors are making use of those instruments.").

[262] Tax Aspects of Derivative Financial Instruments, 49th IFA Cong. Res. (Cannes 1995). See also Michael Cosgrove, *IFA Stresses Role of Derivatives, Calls on Nations to Establish New Tax Regimes*, 65 BNA's Banking Rep. 507 (1995).

[263] See Avi Yonah and Swartz (1997).

practical: (i) different classes of taxpayers and different instruments that are economically similar should be similarly treated; (ii) the rules must apply consistently over time as derivative instruments change; and (iii) the use of derivative instruments should have definite and predictable results.[264]

The IFA Report (1995) also discussed the appropriate source rules for income from derivatives and sets forth that:

> Countries should not impose source basis taxation on income derived by non-residents from derivative instruments in the absence of a branch or permanent establishment to which such income is attributable.
>
> It is the general practice not to impose withholding tax at source on payments made under derivative financial instruments. This is appropriate and should be universally adopted
>
> Apart from withholding tax, profits, gains and losses with respect to derivative instruments should be exempted from tax at source under domestic law or applicable income tax treaties on the ground that they represent:
>
> - business profits, exempt from tax in the absence of a permanent establishment
>
> - capital gains; or

[264] Id.

- "other income" exempt under the "other income" article of an applicable treaty.[265]

Six years later, Victor Thuronyi (Senior Counsel (Taxation) with the International Monetary Fund) stated that the same rationale should apply to developing countries:

> In the case of certain [New Financial Instruments], particularly derivatives, tax policy concerns militate against the imposition of a withholding tax because the payments under some financial instruments may not be closely correlated with the income actually earned. This is particularly the case for swap payments. There is a risk, therefore, that if a gross basis tax is imposed at source, taxpayers simply will not enter into the type of transaction subject to withholding, because the withholding would be out of proportion to the amount of income involved. [footnote omitted] Such a policy may deny to domestic companies the risk-shifting benefits that new financial instruments can provide.[266]

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[265] See the IFA Report (1995) at para 2.3. Paragraph 2.4 elaborates that "In imposing residence taxation on income derived from derivative instruments, the residence principle should be: (a) reinforced by application of a country's anti-deferral regimes, where appropriate; and (b) clarified in the case of global trading, split hedging, and interbranch transactions. In this connection, countries should consider entering into Advance Pricing Agreements in appropriate cases. In computing the taxable income of a branch of a foreign taxpayer, inter-branch or branch/home office transactions in derivative instruments are taken into account in some countries but not in others. The treatment of these transactions should be harmonized and the OECD should be encouraged to continue its work on the subject."

[266] See Thuronyi (2001) at 261, citing for this view C. Plambeck, H.D. Rosenbloom, and D. Ring, "General Report," 85b Cahiers de droit fiscal international (1995); L. Lokken, "Taxation of derivatives and new financial instruments," in Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the Work of its Eighth Meeting (UN 1998).

Note that Mr. Thuronyi specifically acknowledges that domestic businesses will benefit from more access to risk-shifting instruments if the souce country will not withhold on such instruments.

Another potential policy argument for these source rules is that, in contrast to payments on stock or debt, where the recipient has invested capital in an income-producing asset in Country D, a swap is merely a contractual arrangement that gives rise to cash flows on a notional amount.[267] Interest and dividends can flow only to the investor, but cash flows on notional principal contracts can flow in either direction. While Country D may wish to reserve the right to taxing priority on income from capital invested therein, there is no reason for a priority claim for taxation of cash flows on contractual cash flows out of the country.[268]

As set forth above, in the United States, the IRS and several commentators have raised the concern that with respect to equity swaps, such source rules could be used to replicate payments subject to U.S. withholding, such as dividends from a U.S. corporation, and convert such payments into exempt swap payments.[269] These concerns, however, should

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[267] See Garlock et. al. (2005).
[268] Id.

[269] See Yaron Reich (1998); Preamble to prop. Treas. reg. section 1.864(b)-1, (June 11, 1998); Preamble to the Section 446 Regulations, T.D. 849, 58 Fed. Reg. 53125 (Oct. 14, 1993) ("[T]he IRS is considering whether notional principal contracts involving certain specified indices (e.g., one issuer's stock) should be excluded from the general sourcing rules of *Section 861* through 865..."); Preamble to Proposed Regulations under Section 1058, 1992-1 CB 1196 ("The Service is considering whether the proposed regulations should apply to dividend equivalent payments made in connection with certain notional principal contracts, such as an equity index swap structured to replicate the cash flows that would arise from an installment purchase of one or more equity securities"); New York State Bar Ass'n Tax Section, "Report on the Imposition of U.S. Withholding Tax on Substitute and Derivative Dividend Payments Received by Foreign Persons," Highlights & Documents, June 5, 1998, p. 2869; Avi-Yonah and Swartz (1997); Colon (1999).

not apply if consistent with my proposals in the previous part, interest and dividends are largely exempt from withholding tax.

d. Taxation of Cross Border Derivatives under Treaties

The characterization of payments for treaty purposes is important because different characterization could mean different rates imposed on income from cross-border financial instrument.[270] In addition, special issues may arise if the payment is characterized inconsistently in the country of source and the country of residency.[271]

"The existing network of tax treaties places significant constraints on countries' freedom of action in imposing a withholding tax on derivatives."[272] Generally, income from derivatives could fall under business income (Article 7), dividends (Article 10), interest income (Article 11), capital gain (Article 13) or other income (Article 21).[273] Under all provisions, according to both the U.S. and OECD models, income would generally be taxable only in the residence country.[274]

There is little doubt that when income from derivatives is attributable to the non-resident's permanent establishment in the source country, such income should be taxed

[270] For example, as discussed above, if a payment is classified as interest, it may be subject to lower rates then if such payment would be treated as a dividend.
[271] For examples of how foreign investors can avoid U.S. withholding taxes using derivatives, *see* Colon (1999); Gregory May, *Flying on Instruments: Synthetic Investment and the Avoidance of Withholding Tax*, 73 Tax Notes 1225 (1996); Thuronyi (2001).
[272] Thuronyi (2001) at 268.
[273] See Bruce A. Elvin, *The Recharacterization Of Cross-Border Interest Rate Swaps: Tax Consequences and Beyond*, 96 TNI 32-21 (citing from Organization for Economic Co-operation and Development, Taxation of New Financial Instruments (1994); Thuronyi (2001) at 268-9.
[274] Id.

by the source country under Article 7.[275] Of course, as discussed above, this will require a two-step determination of whether the non-resident has a permanent establishment in the source country and if so, whether the income is attributable to such permanent establishment.

The dividend articles of many U.S. tax treaties generally define dividends as "income from shares . . . as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares" in the country where the distributing company resides.[276] According to May (1995), this could establish the authority to tax payments under an equity swap.[277]

As to the interest article, in general, payments under a derivative are not treated as interest because they are not compensation for the use of money.[278] The only case where payments under a derivative could be subject to the interest provision is in the case of a significant non-periodic payment in a swap that could be treated as an embedded loan under the source country's domestic laws.[279]

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[275] Id.
[276] See May (1995), citing 1981 U.S. Model Income Tax Treaty, Article. 10(3).
[277] Id. See also Avi Yonah and Swartz (1997).
[278] Thuronyi (2001) at 269.
[279] Id. (Illustrating as follows: "party A makes a payment to party B of US $ 1,000, then B pays A US $ 100 for 5 years and US $ 1,100 in the sixth and final year. This is nothing but a loan at 10 percent annual interest, even though the payments are called swap payments. Under a rule that treated as interest the implicit interest due to differences in timing of payments under a swap, an appropriate portion of the payments would be characterized as interest.").

Nevertheless, some treaties do not follow the existing models as far as the "other income" article is concerned, or do not contain an "other income" article.[280] Moreover, under the U.N. Model Treaty, "other income" arising in a contracting state may be taxed in that state (*i.e.*, the source country).[281] "Thus, a country which has followed the UN Model in its treaties will be able to impose a tax on payments under derivatives if it wishes, in circumstances where these payments are properly characterized as other income."[282]

As of today, there is no specific provision in any tax treaty that allocates the tax on income from derivatives.[283] It is, therefore, strongly suggested that countries will consider adopting a specific provision in their tax treaties to address this issue. Consistent with the international consensus over the appropriate treatment of income from derivatives discussed in this article, such a provision should specify that income from a derivative transaction should generally be taxed by the residency country, unless it falls under other treaty provisions such as interest (in the case of embedded loans). Obviously, the U.S., OECD and U.N. can assist in revising their treaty models to include specific rules for derivatives.

D. Investing and Trading in Securities

[280] Thuronyi (2001) at 269. (The "other income" article exists in most U.S. treaties and in most cases; it allows the country of residency to tax unspecified "other income." *See* for example, treaties with Germany, France and the Netherlands, and article 21(1) to the 1996 U.S. Model Income Tax Treaty).
[281] Id.
[282] Id.
[283] See OECD Report (1994) ("there is no consistency in the way countries classify [derivatives] payments when applying treaties.").

As set forth above, if a foreign person conducts business activities in the United States, it will generally be subject to U.S. income tax on its income effectively connected with that trade or business.[284] This standard is generally accepted by most countries as well as in tax treaties (only the standard is income that is “attributable” to a “permanent establishment”).[285]

The U.S. Tax Code provides safe harbor exceptions, however, for business activities that consist of (i) trading in securities and commodities through an independent agent in the United States (if the taxpayer does not maintain a U.S. office through which the transactions are effected) and (ii) for trading in securities and commodities for the taxpayer’s own account (if the taxpayer is not a dealer).[286] In general, this safe harbor is applicable to traders and investors in securities but not to dealers.[287]

“Securities” are defined for this purpose as "any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing; and the effecting of transactions in stocks or securities includes buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the

[284] See *InverWorld v. Commissioner*, T.C. Memo 1996-301, at 72.
[285] See, for example, Bernstein, Jack, Jondahl, Sky and Nicholls, Andrew,*Canadian Tax Treatment of Index Participation Units And Exchange- Traded Index Derivatives*, 37 Tax Notes Int’l 587 (2005).
[286] Pursuant to Section 864(b)(2)(A)(ii), a non-resident is not treated as being engaged in a trade or business within the United States for trading in stocks or securities on its own account, either directly or through an agent. Section 864(b)(2)(B) provides safe harbor for trading in commodities.
[287] See sections 864(b)(2)(A)(ii)-(B)(ii). For the definition of a “dealer” for this purpose, see David Hariton, (on behalf of the New York State Bar Association Tax Section), *Credit Default Swaps*, 40 Tax Notes Int'l 545 (Sept. 09, 2005) (“dealers transact with customers, while traders and investors act for their own account.”)

account and risk of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading)."[288]

While these safe harbors were originally enacted prior to the explosion in the use of derivatives, the Treasury and the IRS have endeavored to modernize the rules by issuing proposed regulations that would extend the safe harbors to trading in a wide variety of derivatives, including interest rate, currency, equity and commodity notional principal contracts.[289] In many cases, derivatives are entered into for the purpose of hedging a position in stocks, securities, or commodities, and the securities and commodities trading safe harbors apply to such derivatives.[290] Thus, non-residents trading in securities and derivatives in the United States will not be treated as having income that is effectively connected to a US trade or business.[291] Dealers in derivatives and securities, however, will be subject to U.S. tax, as discussed below.

The United States Congress first enacted the securities trading safe harbor in 1936 to provide certainty that non-residents who merely trade stocks and securities would not be subject to the net income tax regime.[292] The two-prong rationale was that: (i) ordinary income from U.S. stocks and securities (e.g., interest and dividends) would be subject to U.S. taxation through the withholding tax on FDAP income, and (ii) activities beyond the

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[288] Treas. Reg. 1.864-2(b)(2)(i).

[289] Prop. Reg. § 1.864(b)-1, 63 F.R. 32164-32166 (“According to the Service, regulations on the safe harbor provisions in section 864(b) have not been issued since 1972. Since then, it says, the use of derivative financial instruments has increased significantly. To reflect that development, the Service says, new regulations addressing the ways taxpayers customarily use derivative transactions are needed.”).

[290] Treas. Reg. 1.864-2(c)(2)(i), (d)(2)(i).

[291] See May (1995).

[292] Section 211(b), Revenue Act of 1936, Pub. L. 74-740, 49 Stat. 1648, 1714-15 (1936); S. Rep. No. 2156, 74th Cong., 2d Sess. 21 (1936).

scope of the safe harbor (e.g., dealers) would be subject to net tax if the taxpayer was engaged in a trade or business or had an office in the United States.[293]

Thirty years later, the Foreign Investors Tax Act of 1966 expanded the safe harbors to include trading activities conducted by or on behalf of a non-U.S. resident taxpayer through a U.S. office for the foreign taxpayer's own account.[294]

The unmistaken purpose of these safe harbors was to encourage foreign persons to invest in U.S. capital markets without subjecting them to U.S. income tax.[295] The safe harbors are generally very broad and aimed at various types of passive investments.[296] The

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[293] Id.

[294] See Section 102(d), Foreign Investors Tax Act of 1966, Pub. L. 89-809,80 Stat. 1539, 1544 (1966); S. Rep. No. 1701, 99th Cong., 2d Sess. 16-17, 22-23, 32-33 (1966).

[295] H. Rep No. 1450, 89th Cong., 2nd Sess. (1966), p. 6. See also David Hariton, (on behalf of the New York State Bar Association Tax Section), *Credit Default Swaps*, 40 Tax Notes Int'l 545 (Sept. 9, 2005) ("For foreign entities, a special statutory rule provides that foreign entities that are traders or investors (but not dealers) in securities or commodities may carry on their securities activities in the United States without being subject to U.S. net income tax, but subject to U.S. withholding tax applicable to investment flows. Under congressional policy dating back to the 1940s, those safe harbor rules have been amended by Congress and interpreted by the IRS in a manner that encourages offshore investors, including special purpose vehicles managed by U.S. investment advisers, to invest and trade in U.S. securities."); Colon (1999) at 783-4 ("To encourage foreigners to invest in U.S. capital markets without becoming engaged in a U.S. trade or business, Congress enacted two statutory safe harbors in the Foreign Investors Tax Act of 1996, one for trading in securities and commodities through an independent agent and the other for trading for the taxpayer's own account in securities and commodities."); Yaron Reich (1998).

[296] See H.R. Rep. No. 1450, 89th Cong., 2d Sess. 55 and S. Rep. No. 1707, 89th Cong., 2d Sess. 80 ("a nonresident alien individual or foreign corporation who is not a dealer in stocks or securities is not engaged in trade or business within the United States by reason of trading in stocks or securities for the taxpayer's own account, *irrespective of where the activities instrumental to such trading are performed or how the actual trading transactions are effected*. It is immaterial whether the corporation or individual conducts the trading activities and effects the stock or security transactions himself or through his employee or uses agents in the United States, whether independent or dependent, to perform any or all the functions instrumental to such trading. It is also immaterial whether any such employee or agent, wherever located, is authorized to exercise his own discretion in trading activities conducted, or in effecting transactions, on behalf of his employer or principal. Moreover, the volume of stock or security transactions affected during the taxable year is not material ... [Emphasis added.].

volume of trading does not matter, as long as there is no fixed place of business in the U.S.[297]

Another important reason for the trading insecurities exemption was that taxing such non-residents on gains from trading in securities is impractical. As set forth in the legislative history of section 864(b):

> [A] nonresident alien will not be subject to the tax on capital gains, including so-called gains from hedging transactions, as at present, it having been found administratively impossible effectually to collect this latter tax. It is believed this exemption from tax will result in considerable additional revenue from the transfer taxes and from the income tax in the case of persons carrying on the brokerage business.[298]

I believe that similar securities trading safe harbors should similarly apply to investors and traders conducting business in Country D because the same policy considerations that led the United States' Congress to encourage passive investment by foreign investors in the United States are applicable to developing countries.

[297] Id. see also Reg. §§ 1.864-2(c)(i) and (d)(i).
[298] Senate Report No. 2156, 74th Cong., 2d sess., p. 21.

As to tax treaties, as discussed above, the source country generally can tax gains attributable to a "permanent establishment." Thus, non-resident with no "permanent establishment" in the host country will be taxed in the residency country:

> A foreign person engaged in derivative transactions has a U.S. permanent establishment if the person or a dependent agent has a U.S. office through which it regularly takes material steps to acquire, manage, or dispose of derivative contracts. [footnote omitted] As a practical matter, foreign persons in the derivatives business will have a permanent establishment if they have a fixed place of business under the U.S. domestic rules.[299]

E. Credit Default Swaps (CDSs)

A recent debate in the United States over the appropriate tax treatment of cross-border CDSs illustrates that the United States still considers tax measurements to attract foreign counterparties to transact with domestic businesses.[300]

In a typical CDS transaction one party (the "Protection Buyer") enters into a contract with another party (the "Protection Seller, typically a foreign party) to obtain the right to a payment in the event of a default (the "Default")[301] by a third-party obligor (the

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[299] See May (2005).
[300] See Notice 2004-52, 2004-32 I.R.B. 168 (Aug. 9, 2004).
[301] In general, a Default constitutes an issuer's failure to make payments on any of its obligations when due, typically upon insolvency or bankruptcy. *See* David Nirenberg and Steven Kopp, *Tax Treatment of Total Return Swaps, Default Swaps and Credit Linked Notes*, 87 J. TAX'N 82 (1997) (hereinafter "Nirenberg and Kopp (1997)"). Credit events may also include a specified price change in the Reference Entity's debt or a rating downgrade. *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for*

"Reference Entity") on a debt obligation issued by that entity (the "Reference Obligation"). The Protection Buyer need not own the Reference Obligation. The Protection Buyer pays the Protection Seller either a single lump sum or periodic payments.[302] In return, the Protection Buyer has the right to receive either (i) a cash payment, equal to the difference between the Reference Obligation's value at the date the CDS was established and its value at the time of the Default, or (ii) the right to deliver the Reference Obligation to the Protection Seller for cash equal to its face amount.[303] A CDS can cover the credit risk of a single Reference Obligation, various debt obligations of a single Reference Entity, or a group of Reference Obligations issued by different entities.[304]

In general, taxpayers other than dealers enter into CDSs for one of the following reasons: (i) a holder of a Reference Obligation can become a Protection Buyer to hedge the credit

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the Credit Rating Agencies, 77 Wash. U.L.Q. 619, 677 (1999) (hereinafter "Partnoy (1999)"). Thus, a Default may indicate a decline in the creditworthiness of the issuer of the Reference Obligation. *See* Jonathan Talisman and Joseph Mikrut, *Writers Make Second Request for Guidance on Credit Default Swaps* (July 02, 2002), 2002 TNT 148-34 (hereinafter "Talisman and Mikrut (2002)").

302 The periodic payments generally consist of a fixed number of basis points applied to a notional principal amount (equal to the Reference Obligation's value at the time the CDS is entered into). *See* Nirenberg and Kopp (1997). Normally, the Protection Buyer will stop making payments when the Default occurs, and in the absence of Default, will continue making the payments until maturity of the CDS. However, several other alternatives could be contemplated, including, for example, continuing making payment even after the Default.

303 *Id.* Physical settlement generally reflects the net economics of cash settlement because the Protection Buyer is compensated for the reduction in the Reference Obligation's value by allowing it to sell the Reference Obligation to the Protection Seller at par. In the event the Protection Buyer decides to deliver a different obligation, such a different obligation should approximate the post-Default amount of the Reference Obligation. *See* ISDA Comments, 2003 TNT 232-17.

304 Frequently, a CDS will reference multiple obligations. The Protection Seller will pay the Protection Buyer in the event one or more of those Reference Obligations are in default, regardless of whether the Protection Buyer actually holds any of the defaulting obligations. *See* Bruce Kayle, *Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 TAX LAW. 561 (1997), at note 12 (hereinafter "Kayle"). In addition, some CDS contracts allow either the Protection Buyer or the Protection Seller to add or remove a Reference Obligation or obligor from the application of the contract. *See* ISDA Offers Treasury Documents on Treatment of Credit Default Swaps (November 21, 2003), 2003 TNT 232-17 (hereinafter "ISDA Comments 2003").

risk associated with holding the Reference Obligation; (ii) a trader or investor with a portfolio of less risky obligations can become a Protection Seller in order to enhance the yield on that portfolio (at the cost of undertaking additional risk); or (iii) a trader or investor can use a CDS, either as a Protection Buyer or Protection Seller, to take a synthetic long or short position with respect to a Reference Obligation as part of its overall strategy of trying to maximize returns.[305]

In regard to the cross-border aspects of CDSs, the IRS raised two questions in Notice 2004-52: (i) whether a payment to or from a foreign counterparty should be subject to withholding tax in the U.S., and (ii) whether entering into CDS contracts with U.S. counterparties could be construed as the conduct of a U.S. trade or business. In response to the IRS's request for comments, several commentators have indicated that the same reasons that lead Congress to enact the securities trading exception and the source rules for periodic payments on notional principal contracts should apply to CDSs.[306] Accordingly, to allow domestic businesses more access to the CDSs markets, the U.S. should not withhold on payments on CDSs, and the foreign counterparties should not be deemed to have a U.S. trade or business because of their participating in the CDS markets.[307]

[305] See Garlock et. al. (2005).
[306] Id.
[307] Id.

IV. Harmful Tax Competition

A. Overview

As discussed above, Professor Avi Yonah has cautioned in his influential article on globalization and tax competition that the enactment of the portfolio interest exemption in the United States in 1984 created a "race to the bottom" among nations.[308] This "race to the bottom" among countries, according to Professor Avi Yonah, could be viewed as tax competition; not only source countries do not withhold on interest, but also residency countries do not have the ability to levy their taxes on such income; interest income, therefore, escapes taxation by either the source country or the residency country.[309]

Professor Avi Yonah wrote his article shortly after the issuance of the OECD Report (1998), which contains thoughtful analysis of the elements of international tax competition and what measurements should be taken by both OECD and non-OECD members to curb such competition.[310] In 2000, the OECD issued a follow up report

[308] Avi Yonah (2000) at 1581.
[309] Id. at 1583-85.
[310] The OECD Report (1998) was approved by the OECD Council, with abstentions from Luxembourg and Switzerland, on 9 April 1998, and was presented to Ministers on 27/28 April 1998.The report addressed harmful tax practices in both member and non-member countries. Id. para 5.

which, among other things, identified several potentially harmful preferential tax regimes."[311] Both reports are discussed in greater detail below.

B. The OECD Project on Harmful Tax Competition

1. General

"A major contribution of the OECD Report is that it lists factors to be used in identifying tax havens."[312] While the report only addressed tax competition in OECD countries, it emphasized the need for dialog with non-OECD member countries.[313] Paragraph 28 of the OECD Report (2000) elaborated that:

> Harmful tax competition is by its very nature a global phenomenon and there-fore its solution requires global endorsement and global participation. Countries outside the OECD must have a key role in this work since a number of them are either seriously affected by harmful tax practices or have potentially harmful regimes.

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[311] See "Towards Global Tax Co-operation, Report To The 2000 Ministerial Council Meeting And Recommendations By The Committee on Fiscal Affairs" (OECD 2000) (Hereinafter "OECD Report (2000)").

[312] Avi Yonah (2000) at 1659.

[313] See OECD Report (1998) para 13 ("The Committee recognises that since the problems discussed in this Report are of an inherently global nature, it is critical that as many countries as possible are involved in the dialogue. The broader the economic grouping of countries engaged in this dialogue, the greater the effectiveness of any solutions proposed, since this would minimise any displacement of activities to jurisdictions with harmful tax practices outside of the participating countries. Any displacement of activities may put more pressure on the implementation of counteracting measures if such activities are re-established in jurisdictions which operate non-transparent harmful tax practices. It is for these reasons that the Committee has attached particular importance to associating non-member countries with its analytical and policy discussions on harmful tax competition.").

Thus, the OECD project on harmful tax competition is expected to impact not only member states but also many other countries, developed and developing.[314] Nevertheless, while the OECD Report (1998) focused on geographically mobile activities, such as financial and other service activities,[315] it did not specifically address the issues of portfolio interest.[316]

The OECD Report (1998) indicates that "tax havens" and "harmful preferential tax regimes" (see both definitions below) have the potential to cause harm by:

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by all taxpayers;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.[317]

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[314] See OECD Report (2000), para 30 ("It is important to take forward the work of the Forum with regard to eliminating harmful tax practicess on a global basis. To this end, the Committee will encourage non-member economies to associate themselves with the 1998 Report and to agree to its principles; and hold regional seminars that will encourage and assist non-member economies to remove features of their preferential regimes that are potentially harmful.").
[315] OECD Report (1998) para 6.
[316] Id .para 12.
[317] Id. para 30.

Thus, if a certain tax regime contains *all these elements*, it should be treated as "harmful."[318] Nevertheless, regimes that only contain some of these elements may be somewhere in the spectrum between being valid regimes or harmful tax regime.[319]

The OECD Report (1998) distinguishes between three types of situations in which the tax levied in one country on income from mobile activities such as financial and other service activities is lower than the tax that would be levied on the same income in another country:

1. *Tax Havens* - The first country is a tax haven and, as such, generally imposes no or only nominal tax on that income.

2. *Potentially Harmful Preferential Tax Regime* - The first country collects significant revenues from tax imposed on income at the individual or corporate level but its tax system has preferential features that allow the relevant income to be subject to low or no taxation.

3. *Non-Harmful Tax Competition* - The first country collects significant revenues from tax imposed on income at the individual or corporate level but the effective tax rate that is generally applicable at that level in that

[318] Id. para 31.

[319] Id. In a study conducted four years later, the Cato Institute observed that "[o]f the six, it appears that at least four harms -- "distorting financial and, indirectly, real investment flows," "undermining the integrity and fairness of tax structures," "discouraging compliance by all taxpayers," and "increasing the administrative costs and compliance burdens on tax authorities and taxpayers" -- are probably more true of high-tax regimes. The fifth harm cited is hollow bureaucrat-speak: "re-shaping the desired level and mix of taxes and public spending." The sixth harm -- "causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption" -- gets it backwards. The last effect is a desired and expected shift in a globalized economy." See *Cato Study on International Tax Competition,* 2002 TNT 85-51.

country is lower than that levied in the second country.[320]

The OECD Report (1998) does not deal with the third category (which is therefore not discussed in this article), and distinguishes between the first category ("tax havens"), and the second category ("potentially harmful preferential tax regimes.")[321]

2. Tax Havens

A tax regime could be considered a "tax haven" if: (a) it imposes no or only nominal taxes and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their residency country; (b) its laws or administrative practices prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction; (c) its laws lack transparency and (d) it has no requirement that the activity be substantial (which would suggest that it attempts to attract investment or transactions that are purely tax driven.[322]

This article does not endorse adopting any of these elements. Thus, my proposed residency-based regime for financial transactions should not result in Country D being treated as a tax haven under the above standards. The remainder of this part will focus only the second category (*i.e.*, the "potentially harmful preferential tax regimes.").

3. Potentially Harmful Preferential Tax Regimes.

[320] Id. para 38.
[321] Id. para 44.
[322] Id. para 52.

Pursuant to paragraph 59 of the OECD Report (1998), there are four key factors that assist in identifying harmful preferential tax regimes: (a) the regime imposes low or zero effective tax rate on the relevant income; (b) the regime is "ring-fenced"; (c) the operation of the regime is non-transparent; and (d) the jurisdiction does not effectively exchange information with other countries.[323]

A harmful preferential tax regime exists only where the relevant income is subject to low or zero effective tax rate (The first factor) and one or more the other factors also exists.[324] While my proposal would probably satisfy the first factor because I suggest eliminating source-based taxation on several types of passive income, Country D could easily avoid becoming a harmful preferential tax regime by making sure that it would not fall under any of the other three factors, as discussed below.[325]

"Ring-fencing" includes: (i) exclusions of residents from taking advantage of the regime's tax benefits, and (ii) prohibiting enterprises which benefit from the regime from operating in the domestic market.[326]

"Non-transparency" includes: (i) favorable application of laws and regulations, (ii) negotiable tax provisions, and (iii) a failure to make widely available administrative

[323] Id. para 59.
[324] Id.
[325] Other less important factors identified by the OECD Report (1998) include: (i) an artificial definition of the tax base; (ii) a failure to adhere to international transfer pricing principles; (iii) the exemption of foreign source income from tax; (iv) a negotiable tax rate or base; (v) secrecy provisions such as bank secrecy laws or bearer debt; (vi) membership in a wide network of tax treaties; (vii) self-promotion as tax minimisation vehicles; and (viii) the encouragement of tax-driven operations. See Avi Yonah (2000) at 1660, quoting from the OECD Report (1998), para 68-79.
[326] OECD Report (1998), para 62.

practices.[327]

Finally, the lack of effective exchange of information in relation to taxpayers benefiting from the operation of a preferential tax regime is also a strong indication that a country is "potentially harmful preferential tax regimes."[328]

In my view, there is no reason why Country D would not be able to avoid all of these three conditions. In fact, as illustrated in Table 3 below, many countries including the U.S. that provide for preferential treatment of income from financial transaction (i.e., fall under condition number 1) have been able to avoid being classified by the OECD as "potentially harmful preferential tax regimes."

4. The OECD Follow-up Report (2000)

In 2000, the OECD issued a follow up report which, among other things, identified several potentially harmful preferential tax regimes."[329] As illustrated by Table 3, the list of such potentially harmful preferential tax regimes does not include the United States or any other jurisdiction solely because it applies any of the three proposals discussed in this article.[330] Furthermore, as of today, none of such practices has been defined as creating a potential for harmful tax competition.

[327] Id. para 63.
[328] Id. para 64.
[329] See OECD Report 2000, para 10.
[330] Id. para 10-11.

Table 3

Insurance

Finland	Aland Captive Insurance Regime
Italy	Trieste Financial Services and Insurance Centre
Ireland	International Financial Services Centre
Portugal	Madeira International Business Centre
Luxembourg	Provisions for Fluctuations in Re-Insurance Companies
Sweden	Foreign Non-life Insurance Companies
Australia	Offshore banking units
Belgium	Coordination centers

Financing and Leasing

Belgium	Co-ordination Centres
Hungary	Venture Capital Companies
Hungary	Preferential Regime for Companies Operating Abroad
Iceland	International Trading Companies
Ireland	International Financial Services Centre
Ireland	Shannon Airport Zone
Italy	Trieste Financial Services and Insurance Centre
Luxembourg	Finance Branch
Netherlands	Risk Reserves for International Group Financing
Netherlands	Intra-group Finance Activities
Netherlands	Finance Branch
Spain	Basque Country and Navarra Co-ordination Centres
Switzerland	Administrative Companies

Fund Managers

Greece	Mutual Funds/Portfolio Investment Companies [Taxation of Fund Managers]
Ireland	International Financial Services Centre [Taxation of Fund Managers]
Luxembourg	Management companies [Taxation of management companies that manage only one mutual fund (1929 holdings)]
Portugal	Madeira International Business Centre [Taxation of Fund Managers]

Banking

Australia	Offshore Banking Units
Canada	International Banking Centres
Ireland	International Financial Services Centre
Italy	Trieste Financial Services and Insurance Centre
Korea	Offshore Activities of Foreign Exchange Banks

Portugal	External Branches in the Madeira International Business Centre
Turkey	Istanbul Offshore Banking Regime

Headquarters regimes

Belgium	Co-ordination Centres
France	Headquarters Centres
Germany	Monitoring and Co-ordinating Offices
Greece	Offices of Foreign Companies
Netherlands	Cost-plus Ruling
Portugal	Madeira International Business Centre
Spain	Basque Country and Navarra Co-ordination Centres
Switzerland	Administrative Companies
Switzerland	Service Companies

Distribution Centre Regimes

Belgium	Distribution Centres
France	Logistics Centres
Netherlands	Cost-plus/Resale Minus Ruling
Turkey	Turkish Free Zones

Service Centre Regimes

Belgium	Service Centres
Netherlands	Cost-plus Ruling

Shipping

Canada	International Shipping
Germany	International Shipping
Greece	Shipping Offices
Greece	Shipping Regime (Law 27/75)
Italy	International Shipping
Netherlands	International Shipping
Norway	International Shipping
Portugal	International Shipping Register of Madeira

Miscellaneous Activities

Belgium	Ruling on Informal Capital
Belgium	Ruling on Foreign Sales Corporation Activities
Canada	Non-resident Owned Investment Corporations

Netherlands	Ruling on Informal Capital
Netherlands	Ruling on Foreign Sales Corporation Activities
United States	Foreign Sales Corporations

C. Conclusions

In conclusion, my proposed regime for Country D should not constitute "harmful tax competition" for several reasons. First, as discussed above, taxation of passive income by the residency country rather than the source country is consistent with the principles set forth by the League of Nations in both the 1923 report and the 1928 treaty model. This regime is an integral part of the "international tax regime" and has become so fundamental in domestic laws as well as tax treaties, that it is hard to classify it as a "harmful" regime.

Second, as set forth above, the OECD Report (1998) contains several elements the existence of which could result in classifying the tested tax regime as potential harmful preferential tax regime. The list included four facts and the existence of the first one plus any of the other three could result in classifying the tax regime as a potential harmful preferential tax regime. Nevertheless, in my view, while country D would most likely satisfy the first prong, it could easily avoid falling under any of the other three elements. My recommendation, of course, would be to ensure that none of these three elements exist in Country D.

Third, the portfolio interest exemption has never been described by the OECD as creating harmful tax competition.[331] Furthermore, the OECD Report (2000), which identified various tax regimes as tax havens or potential harmful preferential tax regimes, has not identified any of the three proposals set forth in this article as creating harmful tax competition.

Finally, the OECD Report (1998) acknowledged that developing countries may have valid reasons to provide tax incentives to foreign investors even if such policy may be viewed as engaging in tax competition.[332] Specifically, the OECD Report (1998) stated that "countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, etc., frequently consider that special tax incentives or tax regimes are necessary to offset non-tax disadvantages, including any additional cost from locating in such areas."[333]

[331] See Marshall J. Langer, *Harmful Tax Competition: Who are the Real Tax Havens?*, 2001 TNT 19-66 (Jan. 05, 2001) (reviewing "Towards Global Tax Co-operation" (OECD 2000) and arguing that the portfolio interest exemption should be viewed as an attribute of harmful tax competition).
[332] OECD Report (1998) para 27.
[333] Id. See also Avi Yonah (2000) at 1639-48.

V. Conclusions

Developing countries typically struggle between the need to raise tax revenue and the need to attract foreign investors.[334] The decision is even harder in the case of financial investments that are not only highly mobile but also sensitive to taxation. Withholding taxes has the same effect of tariffs by virtue of raising the domestic costs of capital.[335]

As this article illustrates, residency-based taxation for financial transaction is recommended to developing countries for the following reasons: (i) globalization and mobility of capital, (ii) harmonization of the tax system with that existing in developed countries and participating in tax treaties, and (iii) promoting equity, efficiency and simplicity.

My proposed regime will speed up Country D's integration in the globalization process, which in itself has an impact on the size and composition of the public's financial asset portfolio and capital movements. As a practical matter, Country D can learn from other countries' experience and adopt rules that are consistent with common practices in the tax

[334] See, generally, Avi Yonah (2000) at 1639-48.
[335] Merrill et. al. at 1388-9 ("A country that imposes withholding taxes and other barriers to the importation of capital will restrict domestic investment, thereby lowering labor productivity and wages. Thus, for the same reason that countries have sought tariff reductions through the GATT and free trade agreements, it generally is in every country's self interest to seek reciprocal elimination of withholding taxes.").

and accounting arenas in major developed countries. Such consistency will enhance Country D's role in the process of globalization of capital markets.

Furthermore, residency-based taxation in general and for financial transactions in particular has been praised as a method to promote equity and efficiency. Equity is promoted because residency-based taxation reflects better the ability to pay principle. Such a regime would also be efficient since it will minimize the tax system's impact on investment decisions by reducing the distortions caused by the tax system.[336]

In addition, residency-based taxation will reduce compliance costs, since the source-based taxation on interest and dividend income earned by nonresidents is very impractical in many instances. Residence-based taxation, however, would shift revenue from developing to developed countries in the short-run, but as discussed in this article, it would benefit Country D in the long-run.

[336] See Rosenbloom (1996) ("Financial market participants often inveigh against source taxation, particularly source taxation on a gross basis, on the ground that such taxation interferes with marketplace efficiency.")

Appendix: The Tax Reform in Israel (2002)

On July 24, 2002, the Israeli Parliament amended the Income Tax Ordinance ("ITO"), effective from January 1, 2003, in accordance with the recommendations of the Rabinowitz Committee for Income Tax Reform.[337] The reform's major task was to revise the taxation rules for financial instruments, in order to enhance Israel's competitiveness in global financial markets. The reform is discussed below.

The major achievements of the reform are as follows. First, The Reform added new ITO section 4A, which adopted source rules that are similar to those contained in most developed countries, and in most treaties.[338] Second, Israel adopted a residency-based taxation regime that is consistent with the "international tax regime."[339] Third, the reform (and subsequent regulations) modernized the rules pertaining to financial transaction and added rules pertaining to debt and equity, derivatives, short sales, hedging and more. Fourth, Israel adopted several tax measurements to attract foreign investors.

In particular, most types of interest income are now taxed as ordinary income at reduced rates.[340] Furthermore, dividend income is generally subject to flat and reduced rates.[341]

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[337] Law for the Amendment of the Income Tax Ordinance (No. 132) 2002. See generally, Keinan and Menuchin (2003), and Gross, *New Income Tax Laws*, 3rd Edition (2003), at 376.
[338] Particularly, the source of interest is the debtor's place of residency and the source of dividend is the payor's place of residency.
[339] The reform opted for personal taxation for the following reasons: globalization, mobility of capital, harmonization of the tax system with that existing in developed countries, participation in tax treaties, and lack of economic logic inherent in the territorial method.
[340] The Reform introduced reduced rates (10 - 15 percent) for interest received by individuals. Interest income received by corporations remains subject to the general corporate rate of 36 percent.
[341] Pursuant to ITO section 125B, the rate is 25 percent for dividends received by individuals on domestically traded stock. For dividends on stock traded overseas, the rate for individuals is 35 percent

As to capital gains upon sales of securities, individuals and corporations are generally subject to capital gains tax on the sale or exchange of tradable securities and derivatives, Foreign investors are exempt from capital gains tax on the sale or exchange of shares traded on the Tel Aviv Stock Exchange ("TASE"). While the general capital gains tax rate is 25 percent, the capital gain rate for sale or exchange of securities traded on the TASE is 15 percent for indexed securities and 10 percent for unindexed securities, provided that the holder deducted no financing expenses and that the sale is not to a related party.

The reform and subsequent regulations also established basic timing and character rules pertaining to derivative transactions.[342] Under the new rules, a sale, exchange, or retirement of a position in a derivative is subject to the capital gains tax. As to timing, the regulations adopted a "wait and see" approach for derivatives; the gain or loss is not realized until the taxpayer disposes of the underlying asset. The reform, however, did not establish source rules for payments under derivative instruments.

Finally, ITO section 105K defines a hedging transaction as a forward transaction that an investor enters into for the protection of the value of an existing or future asset or obligation, provided that the transaction is identified. The ITO grants the Minister of

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until the end of 2006, and 25 percent beginning January 1, 2007. Corporations are subject to a 25 percent rate on dividends, regardless of where the stock is traded.

[342] ITO section 105K defines options, forward, and futures contracts together as an obligation or right, to deliver or receive, in the future, an amount equal to the differences in the value of a foreign currency, index, interest, property, and property's price, at a specified price, quantity and delivery date, including short sales.

Finance the authority to issue regulations for hedging that have yet to be issued. The definition does not include notional principal contracts; although options, forwards and futures are commonly used for hedging, hedging rules would clearly be incomplete without rules for notional principal contracts.

In conclusion, the reform was the first step in shaping modern tax rules for financial instruments. Nevertheless, the work is incomplete; many gaps in the current rules still exist. For example, there are no current rules for hedging transactions in general, and for notional principal contracts in particular. Some of those gaps are scheduled to be corrected in the coming years, with regulations to be issued by the Minister of Finance. In addition, some rules, such as the definition of options, forwards and futures, are inconsistent with those prevailing in other developed countries.