Chapter 10

International taxation arrangements

Contents

10. INTERNATIONAL TAXATION ARRANGEMENTS

SUMMARY

Australia's international taxation arrangements are consistent with OECD practice and the other OECD-10 countries in the following areas:

- the application of its domestic taxation system to cross-border investment and transactions (inbound and outbound);
- the taxation of temporary residents[1]; and
- the taxation of dividends, interest and royalties paid to non-residents, although some countries have zero withholding tax rates on these payments, while others have extended withholding taxes to a broader range of non-resident income.

In some areas, Australia's international taxation arrangements differ, for example:

- Australia's treatment of the capital gains of non-residents and foreign losses[2]; and
- Australia has an extensive foreign business income exemption for its companies and does not tax foreign business income flowing through Australian companies to foreign shareholders.

The extent of Australia's attribution rules, which prevent residents accumulating passive income (such as dividends and interest) in non-resident entities in low-tax countries to defer Australian tax, is broadly similar to those in other OECD-10 countries. Australia also has other international tax integrity rules, as do the rest of the OECD-10.

10.1 INTRODUCTION

International tax arrangements involve modifications to the normal rules of a country's domestic income tax system where they interact with the tax system of another country as a result of cross-border investments or transactions. They form part of the personal and corporate tax bases and seek to enhance the economic benefits derived from cross-border activities (or limit the economic costs of them). The balance between the costs and benefits of cross-border activities and the consequent international tax rules may vary depending on the circumstances of a particular country.

---

1 The Australian Government announced in the 2005-06 Budget (and has recently introduced legislation to Parliament) measures to align more closely its tax treatment of temporary residents to that of other countries.

2 Reforms announced in the 2005-06 Budget will address these areas and bring Australia into line with other OECD-10 countries.

- For example, inbound foreign direct investment may be valued more highly by a net capital-importing country than by a net capital-exporting country. As a result, the capital-importing country may decide to modify its domestic tax law to a larger degree to accommodate this type of activity (for example, reduce the non-resident withholding tax rate or base). Conversely, if it is in need of more revenue and it perceives its inbound investments as being sufficiently profitable, then it may choose to increase the source taxation on those inbound investments (for example, increase the non-resident withholding tax rate or base).

To compare international tax arrangements, it is necessary to consider the basis on which tax is levied — the residence of the taxpayer or the source of the income. This chapter considers 'residence' and 'source' for international tax purposes (to tax foreign source income), and compares tax residence rules for both natural and legal persons across the OECD-10. It goes on to look at the tax treatment of foreign source income, firstly for individuals (including for temporary residents) and then for companies. It then compares the foreign tax credit (FTC) systems (with a company focus) across the OECD-10.

The tax treatment of the income of non-residents, including conduit income (for example, foreign business income earned by a resident company and distributed to non-resident shareholders), is then considered, followed by commonly used international tax integrity rules. The chapter concludes with a comparison of tax treaty networks and features across the OECD-10.

Box 10.1: Australia and the Review of International Taxation Arrangements (RITA)

Australia recently reviewed many of its international tax arrangements (and continues to implement recommendations/commitments from the review, including the changes announced in the 2005-06 Budget). The review focused on ensuring that, in an increasingly integrated global business environment, Australia's tax system was not hindering its attractiveness as a place for multinational business and investment. One of the key outcomes was the reduction in, and streamlining of, Australia's taxation of inbound, outbound and conduit investment. By doing so, it will potentially raise the attractiveness of outbound investment and regional headquarter activity from Australia, increase its attractiveness to inbound foreign investment and help reduce its cost of capital.

Ensuring that international tax arrangements are not discouraging these cross-border investments is a key focus for many countries, including Australia.

10.2 Residence

Generally, countries tax both residents and non-residents on domestic source income. Tax residence rules usually extend the taxation of residents to their foreign source income.

- Residence is an international tax law construct used to tax the legal and natural persons of a country on their foreign source income. Without such a construct, a country would only be able to tax these persons on their domestic source income (see Box 10.2).

As a result, only resident taxpayers tend to be taxed on their worldwide income whereas non-resident taxpayers are generally only taxed on their domestic source income (see Box 10.3). Some countries have a territorial tax system which only taxes income arising within their own borders, irrespective of the residence of the taxpayer. Key reasons for taxing the foreign source income of residents are to achieve horizontal and vertical equity goals, and to improve the tax neutrality of investment decisions (efficiency).

Box 10.2: Residency rules

All countries have residence tests for both natural persons (individuals) and legal persons (companies). These tests can be based on legal form and/or economic form (substance).

The tax residence of individuals is usually based on either: physical presence in the country (legal form, such as citizenship); facts and circumstances that prove residence in a country (economic substance, such as the country where the person has a fiscal presence); or a combination of the two. In many cases, this may be satisfied simply by being present in a country for a set period of time, such as 183 days.

The tax residence of companies (that is, where companies are established or carry on business) is usually based on either place of incorporation (legal seat), location of management (real seat) or a combination of the two.

Residency rules have an important role to play in tax treaties as they clarify the right to tax and assist in the avoidance of double taxation.

Box 10.3: Source rules

Broadly, source rules operate to identify income arising within a country's geographical boundaries.

The term 'source' is not defined in Australia's tax legislation. Australia's source rules are derived from a combination of common law, statutory provisions and Australia's tax treaties. For example, Australia has statutory source rules which identify profits arising from certain import and export sales as having an Australian source.

The common law has developed a range of principles which operate in the absence of statutory provisions. Whether or not the income will be seen to be sourced in Australia under the common law principles is a question of fact in the circumstances of the particular case.

In addition, Australia is largely unique in the world in that its tax treaties contain source rules that empower Australia to exercise taxing rights that are allocated to it by the treaty even when domestic law may not otherwise provide source country taxing rights.

International practice varies as to the nature and extent of the source rules. Generally, countries use geographical boundaries, types of income, or a mixture of both to determine the extent to which they will seek to tax income sourced in their jurisdiction.

Table 10.1 shows for the OECD-10 the basis of the residence test for both individuals and companies.

Table 10.1: Residence tests for individuals and companies

Country	Tax residence test — individuals	Tax residence test — companies
Australia	Facts and circumstances; in practice, high reliance on time present. Individuals deemed a resident if they spend more than one-half of the income year in Australia (unless they can establish a usual place of abode outside Australia and no intention to take up residence).	A company is an Australian resident if it is incorporated in Australia, or carries on business in Australia and has either its voting power controlled by resident shareholders or its central management and control in Australia.
Canada	Facts and circumstances; in practice, high reliance on residential ties. Individuals deemed a resident for entire year if they sojourn to Canada for 183 days or more.	A corporation is a Canadian resident if it is either managed and controlled, or incorporated, in Canada.
Ireland	Facts and circumstances; in practice, high reliance on time present. Individuals deemed a resident if they spend 183 days or more in Ireland during the tax year. Also deemed a resident if they spend 280 days in that year and the previous year taken together in Ireland.	A company is an Irish resident if it is managed and controlled in Ireland. All new companies incorporated in Ireland are regarded as resident for tax purposes, however this does not apply to a company if: (1) it (or a related company) carries on a trading activity in Ireland, and: (i) it is under the control of persons resident in an EU member state or in a treaty country; or (ii) is (or is related to a company which is) quoted on an EU or treaty country stock market; or (2) it is regarded under a tax treaty as being a resident in a treaty country and not resident in Ireland.
Japan	Facts and circumstances; in practice, high reliance on time present. An individual is a resident if they have a domicile or have maintained a residence in Japan continuously for one year or more. Residents are either permanent or non-permanent (non-permanent if they do not intend to stay in Japan, unless they continued to maintain a domicile or residence for more than five years). A permanent resident is a resident other than a non-permanent resident.	A company is a Japanese resident if it is incorporated, or has its head office, in Japan.
Netherlands	Facts and circumstances; in practice, high reliance on personal and economic ties (especially the centre of economic and social interests). No time limits are mentioned as an indicator of residence.	Company is treated as resident in the Netherlands if: (1) it is incorporated under Dutch law, generally as an NV (public limited) or BV (private limited) company; or (2) it is actually situated in the Netherlands. A principal criterion is the location of the company's central management.
New Zealand	Facts and circumstances; in practice, high reliance on time present. Deemed a resident if present in New Zealand for an aggregate of 183 days or more in any 12-month period. Also resident if an individual has a permanent place of abode in New Zealand (social and financial associations are relevant here).	A company is a New Zealand resident if it is incorporated in New Zealand, it has its head office in New Zealand, its centre of management is in New Zealand or the directors (acting as directors) exercise control of the company in New Zealand. The head office of a company means the centre of its administration management.
Spain	Time present in Spain, and centre of vital economic and business interests are main factors. A person will be resident in Spain if they stay there for more than 183 days in any calendar year.	A company is a Spanish resident if it is incorporated in Spain, has its registered office in Spain or has its place of management there.
Switzerland	Facts and circumstances; in practice, high reliance on time present. Deemed a resident if carrying on gainful activity in Switzerland for more than 30 days or if in Switzerland for more than 90 days (without a gainful activity). The centre of an individual's personal and economic interests is also decisive.	A company is a Swiss resident if it is incorporated, or if its place of effective management is, in Switzerland.

Table 10.1: Residence tests for individuals and companies (continued)

Country	Tax residence test — individuals	Tax residence test — companies
United Kingdom	Facts and circumstances; in practice, high reliance on time present. Individual regarded as a resident for an income tax year if they spend an aggregate of 183 days in the United Kingdom for that tax year, or if habitually visiting the United Kingdom for more than 91 days or more in four consecutive years (residence from the fifth year). There is also strong reliance on the maintenance of a permanent home in the United Kingdom.	A company is a United Kingdom resident if its central management and control is in the United Kingdom, or it is incorporated in the United Kingdom.
United States	Time present in the United States, lawful permanent residence and citizenship. An individual is treated as a resident of the United States under the substantial presence test for a calendar year if: they spend 31 days or more in the United States; or if the sum of the days present in the United States during the current year, plus one-third the number of days present in the first preceding calendar year, plus one-sixth the number of days present in the second preceding year, equals 183 days or more.	A company is a United States resident if it is incorporated under the laws of any State in the United States.

Source: Various, see Chapter 1 (1.4.1).

Most of the OECD-10, including Australia, supplement their residence tests for both individuals and companies with substance-based tests. Without these tests, individuals and companies may be able quite easily to reduce or avoid worldwide income taxation by migrating (in legal form) to a low-tax country without their underlying economic circumstances changing.

For individuals, the majority of the OECD-10, including Australia, have a residence test based upon the facts and circumstances of the case. The most common factor appears to be time present in the country. Most countries consider that around six months (183 days) is sufficient to establish residency unless there are other facts to suggest otherwise regardless of time spent.

For companies, only the United States relies solely on the incorporation test to establish residence.[3] All other countries in the OECD-10, including Australia, have some form of management or control test as a part of their company residence test.

10.3 Treatment of foreign source income

10.3.1 Treatment of an individual's foreign source income

As noted, resident individuals are generally taxed on their worldwide income while non-resident individuals are generally only taxed on their domestic source income. But some individuals have features of both residents and non-residents. A common example is foreign long-stay individuals, often referred to as 'temporary residents' or 'expatriates', who may work in a country for more than half a year (when they might ordinarily become residents)

3 The United States has experienced some difficulties in recent times with resident companies migrating in legal form to low-tax countries in part because of such a black and white test.

but are not permanent (for example are on work visas — quasi-non-resident). Many countries specifically cater for these individuals by not taxing them on their worldwide income unless their temporary nature becomes permanent (however determined). These rules are intended to improve the attractiveness of countries to internationally mobile labour.

Table 10.2 shows for the OECD-10 what constitutes temporary residence and compares the tax treatment of their income with that of ordinary resident and non-resident individuals.

Table 10.2: Comparing tax treatment of temporary residents (expatriates) with resident and non-resident individuals

Country	Key temporary residence rules (expatriates)	Liability to tax	Tax rates	Tax base (including social security contributions/obligations of employees and employers)
Australia(a)	No specific rules exist for temporary residents. There are some exemptions for short-term and 'exempt' visitors.	Residents: worldwide income. Expatriates: there is no separate category of temporary residents, so liability to tax depends on status as resident or non-resident. There is a limited exemption for 'exempt visitors' from the foreign investment fund rules for four years provided they are holders of a temporary visa. Also an exemption from the CGT deemed disposal rule (which applies when residents become non-residents) for short-term residents (that is, individuals who have only been residents for less than 5 of the past 10 years) on pre-residence or bequeathed assets. Non-residents: Australian source income.	Income: residents are taxed at reduced rates, compared with non-residents, at incomes less than A$21,600. Capital gains: other than difference in rates referred to above, no difference between non-residents and residents (capital gains are aggregated with income).	Income: minor relief for support of dependants available to residents. Medicare (compulsory medical insurance system) rights and obligations are not applicable to non-residents. Capital gains: comprehensive (residents) Australian land, business assets and direct interests in Australian entities (non-residents). Expatriate treatment of capital gains will depend on whether they are considered a resident or non-resident. Gains are included in taxable income, and therefore potentially subject to different rates as between residents and non-residents.

Table 10.2: Comparing tax treatment of temporary residents (expatriates) with resident and non-resident individuals (continued)

Country	Key temporary residence rules (expatriates)	Liability to tax	Tax rates	Tax base (including social security contributions/obligations of employees and employers)
Canada	None	Residents: worldwide income. Expatriates: n/a. Non-residents: Canadian source income.	Income: no difference between residents and non-residents. Capital gains: no difference between residents and non-residents.	Income: minor relief for support of dependants available to residents. Canada has a provincial medical insurance system. The method of funding varies from province to province. Compulsory medical insurance system rights and obligations are not applicable to non-residents. Employees and employers must contribute to the employment insurance fund. The maximum contribution for an employee is C$729 and for employers C$1,021 (employee contributions are C$1.87 and employer contributions are C$2.62 per C$100 of Insurable earnings); maximum Insurance earnings is C$39,000. Access to most social programmes is restricted to residents. Canadian pension plan contributions are required on annual earnings (as at 2005) exceeding C$3,500 (to max of C$41,100); contribution rate is 4.95 per cent of such earnings (split between employer and employee). Some jurisdictions in Canada impose a formal payroll tax (Newfoundland, Manitoba, Quebec, Ontario, the Northwest territories and Nunavut). Capital gains: comprehensive (residents) Canadian land, Canadian business assets and direct interests in Canadian companies and trusts (non-residents).
Ireland	Resident, but not ordinarily domiciled in Ireland.	Residents: worldwide income. Expatriates: income from an Irish source and United Kingdom employment and other foreign source income remitted to Ireland. Non-residents: Irish source income.	Income: non-residents are not entitled to potentially lower rates associated with joint assessment. Capital gains: no difference between residents and non-residents.	Income: non-residents are not taxed on interest from government securities. Residents are able to claim interest deductions (capped) on home loans used for a principal residence; non-residents unlikely to have Irish principle residence. All Irish residents are entitled to certain basic health care services. All employees and self-employed individuals other than medical card holders must pay a health contribution levy of 2 per cent of their gross earnings (if annual income is at least €22,880). In terms of social security, all employed and self-employed individuals and employers contribute to the social welfare fund (employers 10.75 per cent on all income; employees 4 per cent on income up to €46,600 (from 2006); self-employed approximately 3 per cent on all income). Social security contributions are not deductible against income. These benefits are largely limited to residents. Capital gains: comprehensive (residents). Comprehensive, but foreign gains only taxed on remittance basis (expatriates). Irish land, Irish business assets and shares in Irish land or business asset rich non-listed companies (non-residents).
Japan	Residents who do not intend to live permanently in Japan, and do not stay for more than five years in any 10-year period.	Residents: worldwide income. Expatriates: Japanese source income and foreign source income remitted to Japan. Non-residents: Japanese source income.	Income: residents are taxed at progressive rates up to 37 per cent (if not a permanent resident, 50 per cent). Non-residents are taxed at a flat rate of 20 per cent. Capital gains: residents taxed at 14-39 per cent (depends on type of gain). Non-residents usually taxed at flat rate of 10 per cent.	Income: non-residents are not entitled to a basic deduction of ¥380,000. Expatriates are entitled to tax free relocation and annual home leave allowances. It is compulsory for an employee or self-employed individual in Japan to join the three social insurance schemes: health, pension, and employees insurance. Health and pension insurance schemes are payable monthly by the employee and employer in equal amounts. Any contributions made by an individual will be deductible for income tax purposes. For expatriates, only Japan sourced payments are chargeable and only if payroll operated in Japan. Capital gains: comprehensive (residents and expatriates); Japanese rights/licences, direct interests in Japanese companies, Japanese businesses and certain securities (non-residents).

Table 10.2: Comparing tax treatment of temporary residents (expatriates) with resident and non resident individuals (continued)

Country	Key temporary residence rules (expatriates)	Liability to tax	Tax rates	Tax base (including social security contributions/obligations of employees and employers)
Netherlands	Expatriates working in the Netherlands with a Dutch company with scarce specific expertise. A time limit of up to 10 years applies (although after five years the tax administration may require proof that expatriate still has the specific know-how).	Residents: worldwide income. Expatriates: either resident or non-resident treatment, at expatriate's election. Non-residents: Dutch source income.	Income: no difference between residents and non-residents. Capital gains: no difference between residents and non-residents.	Income: expatriates can receive 30 per cent of their salary and wages tax free for a maximum of 10 years. Certain personal allowances, minor relief for support of dependants and income-splitting are not available for non-residents. Both employees and other residents are obliged to pay social security premiums under the national social security scheme (approximately 32 per cent of taxable income up to €30,357; people over 65 pay approximately 14 per cent). There is also an additional obligatory social security scheme which covers employees only (premiums apportioned to both employers and employees). Non-residents: EU nationals who come to the Netherlands to work on a temporary basis can apply for a one or two year exemption from paying national social security premiums on the basis of EU legislation. This exemption is available for other non-residents as well if Netherlands has a social security treaty with their home country. As of 2006 a new health care insurance system exists (to replace the old dual scheme). The premium will be 6.5 per cent of salary with a maximum of €1,951. The same treatment exists for residents and non-residents. An unemployment insurance contribution is levied at a rate of approximately 5.2 per cent on annual income between €15,138 and €43,848 (the contribution is deductible). Capital gains: no difference between residents and non-residents.
New Zealand	New Zealand is in the process of amending its laws so that first-time (or first time in 10 years) residents who come to New Zealand for work will be exempt on foreign income other than dividends, interest, employment income and service business income. Limit of five years (or three if not employed on arrival).	Residents: worldwide income. Expatriates: if amendments are passed, foreign source income other than dividends, interest, employment income and service business income will be exempt. Non-residents: New Zealand source income.	Income: no difference between residents and non-residents. Capital gains: no capital gains tax.	Income: minor relief for support of dependent children available to residents. There is no compulsory health or social security insurance. There is a comprehensive accident compensation scheme administered by Accident Compensation Corporation, funded by levies on employers and employees, and self-employed individuals. Levies payable are based on earnings and collected through the PAYE system. The fund pays out for 'accident-related' medical services and for loss of earnings. Capital gains: no capital gains tax.

Table 10.2: Comparing tax treatment of temporary residents (expatriates) with resident and non resident individuals (continued)

Country	Key temporary residence rules (expatriates)	Liability to tax	Tax rates	Tax base (including social security contributions/obligations of employees and employers)
Spain	Individuals (expatriates) who move their residence to Spain to work may opt to be taxed under the Spanish income tax as non-residents.	Residents: worldwide income. Non-residents: Spanish source income.	Income: residents are taxed at progressive rates up to 45 per cent. Non-residents are taxed at flat rate of 25 per cent without deductions or allowances (temporary work is only taxed at 2 per cent). Expatriates: may elect to be taxed as residents (that is, the progressive rates above with certain expenses deductible) or as non-residents (flat rate of 25 per cent, but no deductions) in the tax year they move to Spain and for the next five years. Capital gains: residents are taxed at 15 per cent flat rate. Non-residents are taxed on long-term gains (assets held for more than one year) generally at a rate of 35 per cent.	Income: exempt income for residents includes: indemnities for physical/mental damages; mandatory compensation for termination of employment; disability pensions; child support payments. Deductions allowable for social security contributions and contributions to private pension schemes (non-residents not entitled to these). All *resident* employed and self-employed individuals must pay monthly contributions to the social security system, which consists of a general contribution system and a special contribution scheme. The general system divides employees into professional categories to determine their social security contribution. The general contribution system has a minimum and maximum contribution base that is adjusted annually. For 2006, the maximum monthly base is approximately €2,897.70. Compulsory social security contributions are deductible for individual income tax purposes. Capital gains: there are short-term gains (assets held for one year or less) which are taxed as income, and long-term gains which are subject to a separate capital gains tax (15 per cent). Exemptions exist for individuals' primary residence.
Switzerland	Expatriates are entitled to certain deductions. Expatriates are executives or specialist who are assigned to Switzerland for a period not exceeding five years (as soon as intention to stay for less than five years changes the deductions are no longer available. They are not denied retroactively).	Residents: 'inland income' (generally includes all worldwide sources of revenue from moveable property). Non-residents: Swiss sourced income.	Income: the same tax rates are applicable for non-residents as for residents. Resident immigrants: special rates apply on passive income for a limited period from immigration. Capital gains: no difference between residents and non-residents (Swiss business capital gains are treated as income).	Income: no difference between residents and non-residents. Expatriates may claim specific deductions according to 'sub-national and national' law (for example costs for housing, moving, and travelling). Health insurance is mandatory, but is also the responsibility of the individual (premiums vary depending on the insurance company and age of the individual). Non-residents are not subject to the minimum medical insurance. In terms of social security, employers withhold employees' contributions (old-age survivors insurance 4.2 per cent; disability 0.7 per cent; military compensation 0.15 per cent; unemployment insurance 1 per cent). No contribution is levied on income in excess of CHF106,800. Employees with annual wage exceeding CHF19,350 must contribute to company's pension scheme; contributions vary depending on scheme (the scheme must meet certain standards). Employer has to bear at least one-half of overall contributions of the employee. Capital gains: residents not subject to CGT on gains from movable property or where real estate is held for private investment purposes. Non-residents: subject to CGT on gains from land/building structures in Switzerland and assets used in carrying on a trade/business from a permanent establishment in Switzerland.

Table 10.2: Comparing tax treatment of temporary residents (expatriates) with resident and non resident individuals (continued)

Country	Key temporary residence rules (expatriates)	Liability to tax	Tax rates	Tax base (including social security contributions/obligations of employees and employers)
United Kingdom	Resident, but not ordinarily resident in the United Kingdom (that is, intend to remain for less than three years) or who are domiciled outside the United Kingdom.	Residents: worldwide income. Expatriates: earnings from United Kingdom employment and other foreign source income remitted to the United Kingdom. Non-residents: United Kingdom source income.	Income: no difference between residents and non-residents. Capital gains: no difference between residents and non-residents.	Income: non-residents generally do not get access to the standard deduction. All individuals resident in the United Kingdom for 12 months or more are entitled to free medical treatment under the National Health Service. This is financed out of general taxation (there are no additional specific contributions or taxes). Social security benefits: benefits are divided between contributory benefits and non-contributory benefits. Contributory benefits (unemployment, pensions) are those which are paid to individuals who have the requisite contributions record. The contributions referred to are national insurance contributions (that is, contributions to the National Insurance Fund) out of which contributory benefits are paid. Non-contributory benefits (for example child benefit) do not require a contributions record and are funded out of general taxation. All individuals present in the United Kingdom are liable to pay national insurance contributions, whatever their level of income, once it exceeds a basic threshold. A lower rate of contributions is payable by those employees who are members of a contracted-out occupational or personal pension scheme. Employers are also liable to pay national insurance contributions in respect of their employees. The employers' contributions function as a payroll tax. Expatriates: foreign nationals coming to the United Kingdom do not have to pay national insurance contributions for the first 52 weeks after arrival provided their stay in the United Kingdom is temporary, they are employed by a foreign employer and their normal place of abode before arrival was not the United Kingdom (otherwise liability generally arises immediately upon arrival). Most social security treaties provide that foreign nationals will be exempt from liability to national insurance contributions for a fixed period after arrival, provided they have a certificate from their home country attesting to their continued liability to the equivalent tax there. Capital gains: comprehensive (residents). Comprehensive, but foreign gains only when remitted to the United Kingdom (expatriates). United Kingdom land and business assets (non-residents).
United States	None	Residents: worldwide income. Non-residents: United States source income.	Income: non-residents taxed as per residents but are taxed flat 30 per cent on investment income. Capital gains: no difference between residents and non-residents.	Income: non-residents cannot use married filing or head of household returns. Also, cannot claim dependents exemptions. Residents are able to claim interest deductions on home loans used for a principal residence; non-residents unlikely to have United States principle residence. Residents and non-residents are subject to social security (ie old-age, survivors and disability insurance) and Medicare tax on remuneration paid for services performed within the United States regardless of whether the employee will be eligible for benefits. National law requires employers to withhold social security and Medicare taxes from remuneration. For 2005 the first US$90,000 of remuneration paid to each employee is subject to social security tax at a rate of 12.4 per cent (employer pays 6.2 per cent and withholds 6.2 per cent from the employee's remuneration). The Medicare tax is imposed on the employee's entire remuneration at a rate of 2.9 per cent (employer pays 1.45 per cent and withholds 1.45 per cent from the employee's remuneration). Certain exemptions available to non-resident aliens under social security totalisation agreements, if those non-residents continue to pay social security taxes in home country. Capital gains: comprehensive (residents). Generally exempt, but United States real property gains are taxed at marginal tax rates (non-residents).

(a) Tax Laws Amendment (2006 Measures No. 1) Bill 2006, which includes measures affecting the tax treatment of temporary residents, is currently before the Australian Parliament. If enacted as introduced, these measures will align more closely Australia's tax treatment of temporary residents to that of other countries, in part by generally exempting their foreign non-employment income.

Source: Various, see Chapter 1 (1.4.1).

Table 10.2 shows that temporary residence rules generally limit the tax base to employment income and domestic source investment income. Among the countries that have special taxation rules for these individuals, however, there is a general trend to limit these rules. Limitations can relate to: exempting non-employment foreign income only if it is not remitted to the country; providing that the exemption only applies for a maximum period of time; and providing that the exemption is only available to individuals with scarce specific expertise (that are not generally available in the particular country concerned).[4]

Table 10.2 also shows that most countries apply the same tax rates to residents and non-residents. Where differences in treatment apply, the general trend seems to be for non-residents to be subject to a slightly higher effective tax rate. Australia's approach is consistent with this general trend.

In terms of income, most countries treat residents similarly by taxing worldwide income; they also treat non-residents similarly by taxing domestic source income only. As between residents and non-residents, some countries will often allow residents to claim some deductions and relief not available to non-residents. For countries that have a compulsory medical insurance system, non-residents are usually not covered and therefore not required to contribute.

In terms of capital gains tax, most countries comprehensively tax residents, but limit the taxation of the gains of non-residents to land or real property situated in the country concerned. Australia does not currently have such a limitation.[5]

Countries that levy social security contributions taxes often apply them equally to their residents, temporary residents and non-residents alike. Some countries deny temporary and non-resident individuals entitlement to the related benefits (for example, the United States).

10.3.2 Treatment of a company's foreign source income

As with individuals, resident companies are generally taxed on their worldwide income while non-resident companies are generally only taxed on their domestic source income. Temporary residence tests are not necessary for companies.

Typically, all residents are taxed on their foreign source income unless the income is expressly carved out of the tax base by a foreign income exemption, either unilaterally (in the domestic law) or by a tax treaty with another country. Table 10.2 showed that resident individuals across the OECD-10 are generally comprehensively taxed (with relatively few exemptions) on their worldwide employment, business and investment income. Key reasons for this may be to achieve horizontal and vertical equity goals, and to improve the tax neutrality of investment decisions (efficiency).

---

4 The Australian Government announced in the 2005-06 Budget (and has recently introduced legislation to Parliament) measures to align more closely our tax treatment of temporary residents to that of other countries. Once enacted, Australia will have few restrictions in its temporary residence rules. The main limitation will be simply that the individual hold a temporary visa and not be an Australian resident for social security purposes (whether directly or via their spouse).

5 The reforms announced in the 2005-06 Budget to the capital gains tax treatment of non-residents will bring Australia into line with international practice.

By contrast, resident companies typically receive greater exemptions, particularly on their foreign business income. A key reason for this may be because such exemptions interfere less with goals of horizontal and vertical equity, given the withholding aspect of corporate taxation, and the existence of a subsequent taxing point on company income (when the dividends are distributed to resident shareholders).

Foreign income exemptions for resident companies can be based on:

- the type of income earned (for example business, investment income);
- the type of country the income is sourced from (for example comparable tax, treaty or non-tax-haven countries);
- the type of non-resident entity that earns the foreign income on behalf of the resident company (for example company, superannuation fund, managed fund);
- the degree to which it has been taxed (for example subject to tax, taxed at 75 per cent of the resident company tax rate, taxed by a listed country); or
- a combination of the above.

Table 10.3 shows for the OECD-10 the extent to which resident companies are taxed on their foreign source income, and in particular, the foreign income exemptions they receive.

Table 10.3: Treatment of foreign source income of corporate residents

Country	Taxation of resident companies	Key foreign income exemptions from worldwide income taxation
Australia	Corporate residents subject to tax on worldwide income and capital gains. Foreign income exemptions are extensive (based on active income and active business tests), with FTC system unilaterally covering the rest. Non-exempt foreign losses are quarantined from domestic income on a per-class (of income) basis and can be carried forward indefinitely (and set off against future foreign income of the same class).[a] Foreign affiliate: foreign company in respect of which a resident company owns directly at least 10 per cent of the voting stock (a 'non-portfolio' interest). A foreign affiliate effectively also has a (foreign) affiliate if it owns a non-portfolio interest in another foreign company.[b]	Foreign branch business profits (active income) are exempt. Non-portfolio dividends are exempt, including when paid through a chain of foreign companies. Capital gains on shares in foreign affiliates carrying on an active business are exempt. (Full participation exemption.)
Canada	Corporate residents subject to tax on worldwide income and capital gains. Foreign income exemptions are narrow, with FTC system unilaterally covering the rest. All foreign branch income is assessable with unilateral credit, as are most types of foreign dividends and all other foreign income. Foreign losses are deductible against domestic income without recapture against, or recharacterisation of, future foreign income. Foreign affiliate: foreign company in respect of which a resident company owns (directly or indirectly) at least 10 per cent of the shares of any class.	No unilateral exemptions. Generally, only dividends from foreign affiliates in treaty countries paid out of 'exempt surplus' (active or business income and certain capital gains) are exempt.
Ireland	Corporate residents subject to tax on worldwide income and capital gains. Essentially, there are no foreign income exemptions, and FTC system only partially covers the rest (mainly by treaties). All foreign branch income assessable, with foreign tax generally deducted as business expense (unless treaty applies). Foreign losses are quarantined from domestic income on a per-source basis and can be carried forward indefinitely. Foreign affiliate: foreign company in respect of which a resident company owns (directly or indirectly) at least 5 per cent of the ordinary share capital.	None

Table 10.3: Treatment of foreign source income of corporate residents (continued)

Country	Taxation of resident companies	Key foreign income exemptions from worldwide income taxation
Japan	Corporate residents subject to tax on worldwide income and capital gains. Essentially, there are no foreign income exemptions, with FTC system unilaterally applicable. All foreign branch income and qualifying participation dividends and capital gains are assessable with a credit for foreign tax paid. Foreign losses are deductible against domestic income without recapture against, or recharacterisation of, future foreign income. Foreign affiliate: foreign company in respect of which a resident company owns (directly or indirectly) at least 25 per cent of the voting shares (for previous six months).	None
Netherlands	Corporate residents subject to tax on worldwide income and capital gains. Foreign income exemptions are very broad, with a treaty and developing country-based FTC system, and deduction method of double tax relief, covering the rest. Foreign losses are deductible against domestic income without recapture against, or recharacterisation of, future foreign income (unless the foreign branch is subsequently converted into a subsidiary, in which case prior-year losses may be recaptured against future dividends of the subsidiary). Foreign affiliate: foreign company in respect of which a resident company owns (directly or indirectly) at least five per cent of the issued and paid-up share capital and is subject to tax in its country of residence.	All foreign branch income subject to foreign tax or from a treaty country is exempt, as are qualifying participation dividends and capital gains. 'Exemption with progression' exists (as taxable profit below €22,689 is taxed at 25.5 per cent and at 29.6 per cent above it). Excess exempt foreign losses can reduce future foreign income from the same country.
New Zealand	Corporate residents subject to tax on worldwide income but not capital gains (as New Zealand has no capital gains tax). Foreign income exemptions are effectively narrow, with FTC system unilaterally covering the rest. All foreign branch income is assessable with a unilateral credit. Foreign losses are deductible against domestic income without recapture against, or recharacterisation of, future foreign income.	Foreign source dividends received by companies are exempt from income tax, but subject to foreign dividend withholding payment. (Grey-listed country entities, including controlled foreign companies (CFCs), are generally exempt from attribution.)
Spain	Corporate residents subject to tax on worldwide income and capital gains. Foreign income exemptions are quite broad, with FTC system unilaterally covering the rest. Losses of foreign permanent establishments (PEs) are deductible against domestic income but recapture occurs against future exempt or assessable income of that PE (that is, future PE income is made assessable without credit). Foreign affiliate: foreign company with an active business in a comparable country (that is, a tax treaty country with provisions for Exchange of Information) in respect of which a resident company owns (directly or indirectly) at least five per cent of the capital stock, uninterrupted for at least one year.	Income of PEs, and dividends from (including capital gains on sale of interests in) foreign affiliates, in comparable tax countries, undertaking active business, are exempt.
Switzerland	Corporate residents subject to tax on worldwide income and capital gains. Foreign income exemptions are extensive, with FTC system unilaterally covering the rest. Foreign losses are generally exempt – no quarantining. Exempt foreign income and losses used to calculate marginal tax rate of company (exemption with progression), and therefore FTC cap. Foreign affiliate: foreign company in respect of which a resident company owns (directly or indirectly) at least 20 per cent of the capital or the value of the participation is at least CHF2 million. Participation relief for capital gains has the additional requirement that ownership must be for the previous 12 months.	Income attributable to a foreign business or PE and income from foreign immovable property are exempt. Foreign dividends, interest and royalties only qualify for the exemption if derived through, and attributable to, a foreign PE. A partial participation exemption effectively applies in respect of foreign dividend income — 5 per cent of the grossed-up dividend is excluded from the effective exemption.

Table 10.3: Treatment of foreign source income of corporate residents (continued)

Country	Taxation of resident companies	Key foreign income exemptions from worldwide income taxation
United Kingdom	Corporate residents subject to tax on worldwide income and capital gains. Essentially, there are no foreign income exemptions, with FTC system unilaterally applicable. All foreign branch income and qualifying participation dividends and capital gains are assessable with a credit for foreign tax paid. Foreign losses are deductible against domestic income without recapture against, or recharacterisation of, future foreign income. Foreign affiliate: foreign company in respect of which a resident company owns (directly or indirectly) at least 10 per cent of the voting power.	None
United States	Corporate residents subject to tax on worldwide income and capital gains. Essentially, there are no foreign income exemptions, with FTC system unilaterally applicable. All foreign branch income and qualifying participation dividends and capital gains are assessable with a credit for foreign tax paid. Foreign losses are deductible against domestic income, but recaptured by setting off future foreign income of the same class (recharacterising it as domestic income, which prevents FTCs from arising). Foreign affiliate: foreign company in respect of which a resident company owns directly at least 10 per cent in the voting stock (or owns indirectly at least five per cent in each of the lower tier foreign companies).	None

(a) Implementation of 2005-06 Budget announcement will remove all foreign loss quarantining.
(b) Many OECD countries have foreign affiliate rules which allow resident companies more generous tax treatment of the income and gains arising from their foreign affiliates (for example, exemptions or credits for underlying foreign taxes paid).
Source: Various, see Chapter 1 (1.4.1).

Some countries tax the foreign source income of their resident companies comprehensively (for example, the United States, the United Kingdom, Japan and Ireland) while others allow their companies extensive foreign income exemptions (for example, Australia, Switzerland, the Netherlands, and to a lesser extent Spain).

Australia exempts extensively the foreign income of its resident companies. Foreign 'active' income (trading or business income) is generally exempt, as are the capital gains from the sale of active foreign businesses; generally only foreign income that is passive or arises from related party transactions is taxable at the Australian company level. This active income exemption is quite extensive relative to the other OECD-10 countries (and OECD practice in general), as most have more piecemeal or conditional exemptions.

10.3.3 Foreign tax credit (FTC) systems

Where a resident's foreign source income is not exempt, it remains assessable and potentially subject to double tax. In these circumstances, double tax may be relieved by the resident country, either unilaterally or through treaties, by allowing credits for the tax paid in the foreign country (against the resident country's tax), or the foreign tax to be deducted as an expense of doing foreign business. Box 10.4 provides further detail on the features of FTC arrangements.

Box 10.4: Features of FTC systems

Most countries have FTC systems where certain foreign 'income-like' taxes are creditable with credits being limited or 'capped' by the amount of home country tax payable on the foreign income. Other key defining features of FTC systems include:

- whether only certain foreign income is eligible for FTCs for example, non-passive income;
- whether only foreign income from certain countries is eligible for FTCs for example, treaty countries;
- whether the FTC cap is protected by a form of quarantining, either on a per-class of income, per-country or per-source basis (or multiple bases);
- the treatment of foreign losses; and
- whether FTCs in excess of the cap may be carried forward (or back) a number of years, or are wasted.

Table 10.4 shows for the OECD-10 the key features of their FTC systems.

Table 10.4: FTC system comparison

Country	Key features of FTC system	Treatment of excess FTCs
Australia	Credits available unilaterally and through treaties for foreign income-like taxes. Credits capped at Australian tax payable, and quarantined on a per-class (of income) basis — one active and three passive.[(a)] Dividends from foreign affiliates are exempt (full participation exemption), so no credits or indirect credits for underlying foreign taxes.	Excess FTCs can be carried forward for five years and set off against Australian tax on future foreign income of the same class.
Canada	Credits available unilaterally and through treaties for foreign income-like taxes. Credits capped at Canadian tax payable, and quarantined on a per-class (of income) basis — one business and one non-business class (which includes property and capital gains) — and on a per-country basis. Dividends from foreign affiliates in non-treaty countries paid out of exempt surplus, are taxable as *business* income, with credits and indirect credits for underlying foreign taxes paid, and are quarantined on a per-source basis. Other dividends from foreign affiliates (that is, those paid out of 'taxable surplus', which includes passive income and capital gains), are taxable as *non-business* income, with credits and indirect credits for underlying foreign taxes paid, and are also quarantined on a per-source basis. No tier limit for indirect credits.	Excess FTCs on foreign business income (only) can be carried back three years and carried forward 10 years and set off against Canadian tax on future foreign income of the same class and country. Excess FTCs on foreign non-business income cannot be carried back or forward but may be claimed as a deduction in the year the foreign tax is paid. FTCs on non-business income are used first.
Ireland	Credits available unilaterally (although limited to certain foreign income), through treaties generally, and through certain EU directives, for foreign income-like taxes. Unilateral credit relief limited to foreign dividends (and foreign withholding taxes on the foreign income of certain companies taxed at the special 10 per cent rate, expiring by 2010). Credit relief for all other foreign business income and foreign interest and royalty income only available by treaty. Credits capped at Irish tax payable, and quarantined on a per-item basis generally. Dividends from foreign affiliates are taxable with credit and indirect credits for underlying foreign company (only) taxes paid, and can be pooled with other foreign affiliate dividends. FTCs on non-foreign affiliate dividends are quarantined on a per-item and per-source basis. No tier limit for indirect credits.	Excess FTCs on foreign dividends (only) can be carried forward (indefinitely) and set off against Irish tax on future foreign dividend income. (Under treaties, taxpayer can elect to forgo credit for deduction relief instead.)
Japan	Credits available unilaterally and through treaties for foreign income-like taxes. Credits capped at Japanese tax payable (based on the proportion that taxable foreign income is to overall taxable income), and calculated on a global basis (that is, not quarantined). FTCs are available against national corporation tax, then against prefectural inhabitants tax, then against the municipal inhabitants tax. Dividends from foreign affiliates are taxable with credits and indirect credits for underlying foreign taxes paid, and are not quarantined. Two-tier limit for indirect credits.	Excess FTCs (in addition to excess limitation) can be carried forward for three years and set off against tax on future foreign income.
Netherlands	Credits available only through treaties for foreign income-like taxes. (Credits also allowed for foreign taxes on dividends, interest and royalties from certain developing countries.) Credits capped at the Netherlands tax payable (based on the proportion that the taxable foreign income is to overall taxable income), and quarantined on a per-source and per-country basis. Dividends from foreign affiliates are exempt (full participation exemption), so no credits or indirect credits for underlying foreign taxes.	Excess FTCs can be carried forward indefinitely and set off against the Netherlands tax on future foreign income of the same country.

Table 10.4: FTC system comparison (continued)

Country	Key features of FTC system	Treatment of excess FTCs
New Zealand	Credits available unilaterally and through treaties for foreign income-like taxes. Credits capped at New Zealand tax payable (based on the proportion that taxable foreign income source is to overall taxable income), and quarantined on a per-source and per-country basis. Foreign dividends received by companies are exempt from tax, but subject to foreign dividend withholding payment of 33 per cent of gross dividend. Foreign withholding tax and some underlying foreign taxes can be offset against the foreign dividend withholding payment (indirect credit only where minimum 10 per cent shareholding is satisfied or resident in 'grey list' country). Dividends derived by individuals are assessable with a direct credit only. Three-tier limit for indirect credits.	Excess FTCs are generally wasted (although those arising from a CFC can be carried forward indefinitely or transferred to another company within the same jurisdiction and within a wholly-owned group).
Spain	Credits available unilaterally and through treaties for foreign income-like taxes. Credits capped at Spanish tax payable, and quarantined on a per-country basis generally (although on a per-PE basis for PE income). Dividends from foreign affiliates are exempt. Dividends from foreign companies that are not foreign affiliates but are at least five per cent owned (directly or indirectly) will be entitled to credits and indirect credits for underlying foreign taxes paid, which are quarantined on a per-country basis. Three-tier limit for indirect credits.	Excess FTCs can be carried forward for 10 years and set off against Spanish tax on future foreign income of the same country (or PE).
Switzerland	Credits available only through treaties for foreign income-like taxes (otherwise, exemption or deduction). Credits capped at Swiss tax payable (a third of the overall FTC is allocated to each tier of government) — no quarantining (all assessable foreign income pooled for FTC purposes). Dividends from foreign affiliates are indirectly exempt (as a result of the participation relief ratio). Federal income tax is reduced by the proportion of net foreign profit to total net profit. Treaties allow a tax credit on request for foreign withholding taxes levied on dividends, interest and royalties.	Excess FTCs cannot be carried forward or back at any level of government and are simply wasted.
United Kingdom	Credits available unilaterally and through treaties for foreign income-like taxes (domestic law allows deduction to be claimed in lieu). Credits capped at United Kingdom tax payable, and generally quarantined on a per-source basis. Credits also limited to what the foreign tax would have been if all reasonable steps had been taken to minimise the amount of foreign tax. Dividends from foreign affiliates are taxable with credits and indirect credits for underlying foreign taxes paid, which can be pooled with other foreign affiliate dividends (although dividends from foreign affiliates that are CFCs are quarantined by source). Dividends from other foreign companies are separately pooled for FTC purposes. No tier limit for indirect credits.	Excess FTCs in relation to pooled foreign affiliate dividends can be carried back three years and carried forward indefinitely and set off against United Kingdom tax on future pooled foreign affiliate dividends. This is similarly the case for CFCs, but on a per-source basis.
United States	Credits available unilaterally and through treaties for foreign income-like taxes (domestic law allows deduction to be claimed in lieu). Credits capped at United States tax payable, and quarantined on a per-class (of income) basis — one active and eight passive 'baskets'. For taxable years beginning after 31 Dec 2006, the eight passive income baskets will be reduced to one, leaving two baskets overall. Dividends from foreign affiliates are taxable with credits and indirect credits for underlying foreign taxes paid, quarantined to one of the several passive dividend baskets (depending on the type of foreign affiliate paying the dividend). Six-tier limit for indirect credits (last three must be CFCs).	Excess FTCs can be carried back one year and carried forward 10 years and set off against United States tax on future foreign income of the same class.

(a) Implementation of 2005-06 Budget announcement will remove FTC quarantining by class of income.
Source: Various, see Chapter 1 (1.4.1).

Australia does not appear to differ substantially from the other OECD-10 countries in terms of its FTC system and key attributes. Australia allows significant double tax relief for income from foreign affiliates (generally by exemption) and quarantines foreign losses to a significant degree.[6]

10.4 Treatment of income of non-residents

Non-residents are generally only taxed on their domestic source income. This usually includes payments of dividends, interest and royalties from residents and income earned through a permanent establishment (PE), partnership or trust in the country.

Table 10.5 shows for the OECD-10 the way in which these different types of income of non-residents are treated for tax purposes.

6 The Australian Government announced in the 2005-06 Budget the removal of foreign loss and FTC quarantining. This will remove the per-class quarantining of foreign losses and allow them to be immediately deductible against domestic income. It will also remove the per-class quarantining of FTCs. These changes will significantly improve the way in which Australia treats the foreign income of its residents.

Table 10.5: Treatment of income of non-resident taxpayers[a]

Country	Withholding tax on dividends paid to non-residents	Withholding tax on interest and royalties paid to non-residents	Withholding tax on other income paid to non-residents
Australia	Franked dividends attract no withholding tax. Withholding tax on unfranked dividends is 30 per cent. This reduces generally to 15 per cent in the case of double tax agreements (United States and United Kingdom resident companies may receive a rate of zero or 5 per cent on unfranked dividends received in some cases). The Conduit Foreign Income regime allows foreign source income to pass through to non-resident shareholders without any withholding tax.	The rate of withholding tax on interest is 10 per cent with a broad range of exemptions (including interest paid to United States and United Kingdom resident financial institutions under the United States and United Kingdom treaties). Royalties are subject to withholding tax at 30 per cent. Under most treaties, the rate is reduced to 10 per cent, however other rates may apply, for example, 5 per cent under the United States and United Kingdom treaties.	Withholding tax applies at rates provided in previous columns to dividends, interest and royalties received through partnerships and trusts. Whilst not legally a 'withholding tax', Australian source income derived by a non-resident through a trust (other than the types above) is subject to tax in the hands of the trustee (at the rate applicable to the beneficiary) with credit provided to the beneficiary for the trustee tax paid. Rental income is not otherwise subject to withholding tax (but is likely to be subject to tax by assessment as a PE). Unless otherwise provided in a tax treaty certain shipping activities of non-residents within Australia are subject to Australian tax on a deemed taxable income of 5 per cent of relevant freight income. Australia also collects withholding tax on amounts paid to non-residents in respect of certain insurance, gambling, entertainment and construction activities. However, the amounts withheld are fully claimable against the non-residents final tax assessment.
Canada	The primary dividend withholding tax rate is 25 per cent, but may be reduced to 5 per cent, 10 per cent or 15 per cent subject to various double tax treaties.	The basic rate for interest and royalty withholding taxes is 25 per cent. However, this may be lower subject to tax treaties. For interest withholding tax, it may be 10 per cent to 15 per cent depending on the treaty. Royalty withholding tax is generally levied at a rate of between zero and 25 per cent depending on the treaty. Interest on government debt and arm's length debt is exempt provided that the taxpayer is not obliged to repay more than 25 per cent of the principal within five years.	If a non-resident performs services in Canada, a 15 per cent withholding tax applies. (A waiver may be obtained but only if certain conditions are satisfied.) The tax withheld may be refunded to the non-resident, pursuant to a tax treaty. Management fees, estate or trust income, immovable property, alimony, films, periodic pension and annuity payments, and lump sum pension, annuity or similar type payments taxed at 25 per cent, reduced under treaties.

Table 10.5: Treatment of income of non-resident taxpayers (continued)

Country	Withholding tax on dividends paid to non-residents	Withholding tax on interest and royalties paid to non-residents	Withholding tax on other income paid to non-residents
Ireland	Withholding tax of 20 per cent in general. Irish legislation provides an exemption from dividend withholding tax if certain conditions are satisfied. To qualify for the exemption the Irish company's parent must: • be entitled to the benefit of the EU Parent/Subsidiary Directive; or • be a company resident in an EU/treaty country and not be under the control of Irish residents; or • be a company ultimately controlled by residents of EU/treaty countries; or • be a company whose principal class of shares is traded on a stock exchange in an EU/treaty country, or be a 75 per cent subsidiary of such a company; or • be a company wholly owned, directly or indirectly, by two or more companies which are listed on a stock exchange in an EU/treaty country. In practice this results in most dividend payments to non-residents being exempt from withholding tax.	The basic rate is 20 per cent. In relation to royalties, withholding tax only applies to patent royalties or royalties on an asset which is a passively held asset owned by the non-resident. Further, the EU interest and royalty directive eliminates royalty withholding tax on royalties to certain related EU countries. Many treaties reduce the withholding to 0, 5, or 10 per cent. In relation to interest, Irish legislation provides an exemption for interest withholding tax on interest paid to a company resident in the EU or a treaty country.	Rental payments for Irish-located property payable to non-residents are subject to 20 per cent withholding tax. A retention tax, at the standard rate of tax, must be deducted at source by deposit takers (for example, banks, building societies, Post Office Savings Bank, etc) from interest paid or credited on deposits of Irish residents. The retention tax does not apply to interest on deposits beneficially owned by non- residents.
Japan	The basic rate is 20 per cent but may be reduced by tax treaties to zero per cent (for example, United Kingdom, United States and French treaties), 5, 10 or 15 per cent depending on the treaty. Qualification for reduced rates generally requires shareholding of at least 25 per cent and in the case of United States and United Kingdom shareholders, satisfaction of limitation of benefit tests. 7 per cent (national) final withholding tax at source on dividends paid by a publicly traded company to a non-resident through 31 March 2008.	The basic rate is 20 per cent for interest and royalties (for certain categories of interest, the basic rate is 15 per cent or zero per cent). Reduced treaty rates: zero, 10 or 15 per cent depending on treaty. 20 per cent withholding tax also applicable to certain technical services performed in Japan subject to the business profits article in the applicable tax treaty.	Unless otherwise provided in a treaty, 20 per cent withholding tax on partnership distributions to non-resident partners (one exemption provided). Rental income paid to non-residents for use of real property or industrial or commercial equipment also subject to 20 per cent withholding tax.

Table 10.5: Treatment of income of non-resident taxpayers (continued)

Country	Withholding tax on dividends paid to non-residents	Withholding tax on interest and royalties paid to non-residents	Withholding tax on other income paid to non-residents
Netherlands	Dividend payments to non-residents are taxed at 25 per cent, exempted or reduced to 15, 5, or 0 per cent under treaties. Dividends payable to qualifying EU residents are tax free.	Withholding tax is not collected on interest or royalty payments to non-residents.	Management service fees received in relation to management of a Dutch resident company are subject to corporate income tax in the Netherlands.
New Zealand	Withholding tax on unfranked dividends is 30 per cent. This reduces generally to 15 per cent in the case of double tax agreements. The foreign investor tax credit regime effectively reduces company tax by an amount equal to the dividend non-resident withholding tax (NRWT) paid by the New Zealand company to the extent that the dividends paid to the non-resident are fully franked and the company has paid a supplementary dividend to the non-resident equal to the amount of the NRWT.	15 per cent interest and royalty withholding tax is applicable subject to treaty conditions. Interest payable to arm's length lenders eligible for approved issuer levy, under which interest is exempt from withholding tax but subject to 2 per cent duty. Under New Zealand domestic law, in some cases the NRWT becomes a minimum tax and the interest and royalties may be subject to tax at full rates unless the liability is protected by a treaty.	Where a non-resident provides services in New Zealand, a 15 per cent non resident contractor withholding tax (NRCWT) will apply. This tax is fully creditable against any final tax liability for the non-resident (30 per cent in cases where relevant paper work has not been completed). Excess amounts are refundable. Exemptions may apply if the non resident contractor applies for an exemption certificate from the New Zealand revenue authority. Although not technically a withholding tax, amounts of New Zealand tax are withheld from premiums paid to non-resident insurers.
Spain	Domestic withholding tax on dividends is 15 per cent. This is generally reduced to 10 or 5 per cent in a number of treaties. Dividends paid to non-residents by special regime holding companies out of qualifying income are not subject to taxation in Spain. Under the Parent-Subsidiary Directive, dividends distributed by a Spanish company to a qualifying EU parent are exempt from Spanish withholding tax. There is also draft law for the increase of the dividend withholding tax rate from 15 to 18 per cent with effect from 1 January 2007.	The domestic withholding tax rate on interest and royalties is 15 and 25 per cent respectively. This is generally reduced under treaties. Interest received by an EU resident is generally exempt from Spanish withholding tax. Royalties received by qualifying EU companies are taxed at the 10 per cent rate. Note that Spain taxes royalties paid to non-residents in consideration for the right to use computer software, with few exceptions.	Domestic law establishes a residual 25 per cent withholding tax rate. This applies to payments for services rendered from jurisdictions without a double tax agreement, rental income insofar as it does not qualify as royalties, and employment income. Capital gains obtained by non-residents are taxed at the 35 per cent rate, though a draft Bill put forth by the Government would reduce this to 18 per cent.
Switzerland	Withholding tax is 35 per cent. Individual non-residents benefiting from a treaty may be entitled to a reduction of up to 20 per cent, resulting in residual withholding tax of 15 per cent. Corporations with a substantial investment (usually 20 or 25 per cent) benefit from a reduction resulting in only 5 or zero per cent withholding tax. This holds in particular for parent companies within the EU due to bilateral agreements between Switzerland and the EU.	No withholding tax on royalties. Withholding tax on interest is limited to interest that is paid by a bank or to interest where the underlying financial instrument is a bond. The applicable rate is 35 per cent. Treaty relief is common (usually 10 per cent residual withholding tax).	There is some wage withholding tax (progressive rates) levied on salary earned in Switzerland and on old age pensions from Swiss pension funds.

Table 10.5: Treatment of income of non-resident taxpayers (continued)

Country	Withholding tax on dividends paid to non-residents	Withholding tax on interest and royalties paid to non-residents	Withholding tax on other income paid to non-residents
United Kingdom	Withholding tax is not applied on dividend payments to non-residents.	The withholding tax rate on interest payments ('annual interest') to non-residents is 20 per cent for non-treaty countries and 22 per cent for royalties. The rates are reduced to zero per cent under most treaties, including with the United States and most European countries.	Rental income is subject to 22 per cent withholding tax. Payments made to non-resident entertainers and sportsmen are also subject to 22 per cent withholding tax.
United States	Basic 30 per cent rate may be reduced or eliminated by treaties. United Kingdom, Australia, Mexico and Sweden are examples of treaties which include zero per cent dividend withholding tax. With the other treaties, mostly 5 per cent for corporates with a required percentage ownership, and 15 per cent otherwise.	Basic 30 per cent rate may be reduced or eliminated by tax treaties. Treaties vary greatly in their treatment of interest. A number of treaties exempt interest payments. Royalties generally attract a rate of 0, 5 or 10 per cent.	A branch profits tax which is a dividend equivalent tax applies for branches. Passive income through a partnership treated the same. Not generally covered by treaties, 30 per cent withholding tax on: • gross rent, but can elect to be taxed at the normal United States marginal rates on the net rent; • annuities; • alimonies; • premiums.

(a) The table does not deal with income which is taxed on a net basis such as where it is attributable to a PE.
Source: Various, see Chapter 1 (1.4.1).

The income of non-residents is treated in a variety of ways across the OECD-10, and Australia does not appear to be unique in its framework or treatment. Most of these countries levy all three of the main non-resident withholding taxes (dividends, interest and royalties) through their domestic law. Some OECD-10 countries do not levy one or more of these (for example, United Kingdom and dividend withholding tax), while others have exemptions or significantly reduced rates under treaties, including Australia. The Netherlands levies no interest or royalty withholding taxes and, by virtue of its extensive treaty network, very little dividend withholding tax too.

Australia's dividend withholding tax base is relatively narrow due to a number of significant exemptions (for example, franked dividends and conduit foreign income). It was further narrowed through recent treaties with the United States and United Kingdom. This is also broadly the case for Australia's interest withholding tax base. Where income of non-residents is taxed, Australia's extensive treaty network reduces applicable rates, particularly on dividends and royalties.

10.4.1 Treatment of conduit income

Conduit income typically arises where a non-resident owns an interest in a resident company which pays dividends out of foreign source income. A country can levy tax on conduit income when the resident company earns the foreign income (if the income is not exempt) and when the income is paid by dividend to the non-resident shareholder (for example, dividend withholding tax). Conduit taxation can also arise where the dividend is distributed along a chain of resident companies interposed between the first resident company and the non-resident.

Conduit regimes can help attract multinational operations and regional headquarter activity. A pure conduit regime imposes no domestic tax on foreign income that is eventually paid to non-residents. The more attractive regimes relieve tax at some or all possible conduit taxation points, either unilaterally or through (an extensive network of) treaties. Very few countries (if any) provide full conduit taxation relief in all circumstances.

No Australian tax is levied on dividends paid directly or indirectly (through interposed resident companies) to non-residents out of the foreign income of a resident company. This includes company tax exemptions for any further interposed Australian companies and no dividend withholding tax. When added to the already extensive company tax exemptions for foreign source income derived by resident companies (see Table 10.3), this gives a complete tax exemption for active business profits earned offshore and repatriated through one or more Australian companies to non-residents. Any passive income or gains sourced offshore by an Australian company remains subject to Australian tax but it may be distributed to non-resident shareholders free of any further Australian tax.

Other conduit examples

Similar conduit taxation issues can arise where investment activity is conducted through a domestic funds manager. Broadly, Australia's tax treatment of such arrangements provides a tax exemption for foreign income earned by the Australian funds manager and distributed to non-resident investors.

As an alternative to receiving distributions of foreign profits from interposed Australian companies or fund managers, non-resident investors can access those profits by disposing of their investments. Where that investment is through an Australian funds manager which holds foreign assets almost exclusively, the non-resident investor is now exempt from capital gains tax on the disposal of the investment.[7]

10.5 ATTRIBUTION AND OTHER INTERNATIONAL TAX INTEGRITY RULES

Foreign source income is normally taxed when derived by, or repatriated to, the resident. This enables residents to shift mobile (passive) assets and income to interposed entities in low-tax countries and defer Australian tax. Attribution rules are integrity measures designed to prevent deferral by including passive foreign income in a resident's assessable income as it accrues. As a result, tax does not influence decisions on where to locate assets and income.

Attribution rules often include controlled foreign company (CFC) rules where residents are taxed on their share of certain (usually passive) income of foreign companies they are deemed to have a controlling interest in. Other attribution rules include foreign investment fund (FIF) rules where residents may be taxed on their share of accrued income in foreign portfolio investments.

Through transactions at non-arm's length prices, related parties in different countries can shift income or profits to a lower-tax country (and deductions to a higher-tax country) and avoid tax. Transfer pricing rules are designed to prevent income being shifted in this way by ensuring more economic prices are charged on transactions between related parties.

By shifting debt (and therefore interest expenses and deductions) to higher tax countries, related parties in different countries can also minimise their overall tax. Thin capitalisation rules are designed to prevent uneconomic levels of debt being shifted to a higher-tax country by denying interest deductions above certain limits.

These rules help countries protect domestic and worldwide income tax bases from being lost to low-tax countries, while low-tax countries generally do not need these rules.

Table 10.6 shows for the OECD-10 the attribution and other international tax integrity rules used.

---

7 The Government also announced in the 2005-06 Budget that a similar exemption from CGT would be provided where a non-resident investor disposes of its investment in an Australian company, provided the company's principal asset is not Australian land. When implemented, this change will align Australia's law more closely with OECD practice on capital gains through narrowing the range of assets on which a non-resident is subject to Australian CGT to land and business assets used in Australia. These changes will significantly improve the way in which Australia treats the conduit foreign and other income of its non-residents.

Table 10.6: Attribution and other international tax integrity rules

Country	CFC rules	FIF or other attribution rules	Thin capitalisation rules	Transfer pricing rules
Australia	Yes	Yes — FIF and transferor trust rules.	Yes	Yes
Canada	Yes	Yes — Foreign Investment Entities (FIE) rules.	Yes	Yes
Ireland	No	No	No — besides a basic deemed dividend rule in certain cases for interest payments to a non-resident company or subsidiary in a non-EU or non-treaty country for interests of at least 75 per cent.	No specific rules, although tax authorities may adjust transaction prices between related parties if arm's length principle has not been observed.
Japan	Yes	No	Yes	Yes
Netherlands	No — although for companies, a statutory valuation rule exists where the (fair market value) gain or loss in participations in passive non-resident companies of at least 25 per cent (those with passive assets) of at least 90 per cent is included in taxable income.	No — although for individuals, the worldwide average net value of assets held as at 1 January and 31 December of the tax year is deemed to produce a 4 per cent net yield, flat taxed at 30 per cent (resulting in 1.2 per cent tax on the net assets).	Yes	Yes
New Zealand	Yes	Yes — FIF rules.	Yes	Yes
Spain	Yes	No	Yes	No specific rules, although tax authorities may adjust transaction prices between related parties if arm's length principle has not been observed.
Switzerland	No	No	Yes	No specific rules, although tax authorities may adjust transaction prices between related parties if arm's length principle has not been observed.
United Kingdom	Yes	No	No — replaced on 1 April 2004 by extended transfer pricing rules.	Yes
United States	Yes	Yes — Passive Foreign Investment Companies (PFICs) rules. (Note that Foreign Personal Holding Companies (FPHCs) rules repealed from 31 Dec 2004).	Yes	Yes

Source: Various, see Chapter 1 (1.4.1).

This high level comparison indicates that most of the OECD-10 have CFC rules, while around half have some form of FIF rules. Thin capitalisation and transfer pricing rules are quite common across the OECD-10. Australia has all these integrity rules.[8]

8 The Government's response to the RITA included a commitment to review the FIF attribution rules.

10.6 TAX TREATIES

Tax treaties (or double tax agreements) govern the division of taxing rights between the country where the taxpayer is resident and the country where the income is sourced.

As a net importer of capital and technology, Australia has until recently advocated strong source country taxing rights in its treaty negotiations. As a result, the majority of Australia's past tax treaties provide for withholding tax rates that are higher than the norm in treaties between OECD countries.

Australia's tax treaty policy has moved more toward a residence-based treaty model, reflecting the fact that high levels of withholding tax have been seen to disadvantage Australian companies operating offshore and reduce Australia's ability to attract foreign investment. It seeks to provide a competitive framework for cross-border trade and investment while ensuring that the Australian revenue base is sustainable and suitably protected.

The OECD Model Tax Convention on Income and on Capital (OECD Model) and the tax treaty policy of our key investment partner countries are appropriate benchmarks for considering the comparability of Australia's tax treaty policy. In recent years, Australia has taken significant steps toward a more comparable position by:

- reducing withholding tax (WHT) rates in relation to dividends, interest and royalties (these are now at levels broadly comparable in most respects with the position agreed between the United States, the United Kingdom and Japan);
- aligning our treatment of capital gains with the OECD Model (to be implemented in treaties going forward); and
- including and giving effect to non-discrimination rules.

While in some cases, our practice differs from the OECD Model, it is consistent with countries in similar situations. For example:

- a 5 per cent royalty WHT, where the OECD Model has a zero rate, is broadly consistent with, or lower than, other countries that are net importers of intellectual property, such as Spain, New Zealand and Canada; and
- source taxing rights on income from the exploration for, or exploitation of, natural resources, are broadly consistent with recent treaty practice in resource-rich countries such as the Netherlands, Norway, Denmark and the United Kingdom.

Table 10.7 shows for the OECD-10 the network of treaties in place, their type and key attributes. Australia's current treaty policy will promote tax treaties that are competitive by international standards whilst ensuring that Australia's revenue base is suitably protected.

Table 10.7: Tax treaties

Country	Network	Model predominantly relied on	Key departures from model (with respect to PEs, business profits, withholding taxes and alienation of property)
Australia	42	OECD	**PEs/business profits** • Australia maintains strong source country taxing rights for determining what constitutes a PE. **Withholding taxes** • Australia advocates a 5 per cent WHT rate over royalties (the OECD Model rate is zero). On interest and dividend WHT, the Australian position is in some instances less than the OECD Model tax rate.
Canada	86	OECD	**PEs/business profits** • Canada maintains strong taxing rights over the exploration and exploitation of hydrocarbons. **Withholding taxes** • Canadian tax treaties generally contain a 10 per cent WHT rate on royalties.
Ireland	44	OECD	**PEs/business profits** • Ireland maintains strong taxing rights over the exploration and exploitation of hydrocarbons.
Japan	56	OECD	**Capital gains** • Japan reserves the right to tax gains from the alienation of shares or other corporate rights where the interest is part of a substantial participation (that is, greater than 25 per cent) in a Japanese company.
Netherlands	114	OECD	**PEs/business profits** • The Netherlands maintains strong taxing rights over the exploration and exploitation of hydrocarbons.
New Zealand	30	OECD	**PEs/business profits** • New Zealand maintains strong source country taxing rights for determining what constitutes a PE. **Withholding taxes** • New Zealand tax treaties generally contain a 15 per cent WHT rate on dividends and a 10 per cent WHT rate on royalties.
Spain	106	OECD	**PEs/business profits** • Spain maintains strong source country taxing rights for determining what constitutes a PE. **Withholding taxes** • Spanish tax treaties generally contain WHT rates on royalties of between 5 per cent and 10 per cent. **Capital gains** • Spain reserves the right to tax gains from the alienation of certain substantial interests in a company.
Switzerland	86	OECD	No key departures noted.
United Kingdom	114	OECD	**PEs and capital gains** • The United Kingdom, maintains strong taxing rights over the exploration and exploitation of hydrocarbons.
United States	63	OECD	**Withholding taxes** • The United States excludes investments through certain flow-through entities, (i.e. Real Estate Investment Trusts) from the lower treaty dividend WHT rate.

Source: Various, see Chapter 1 (1.4.1).

REFERENCES

Ault, H and Arnold, B 2004, *Comparative Income Taxation: A Structural Analysis*, Aspen Publishers, Second edition.

Review of Business Taxation, 1998, *An International Perspective: An Information Paper commissioned from Arthur Anderson, examining how other countries approach business taxation*, AGPS.

Rohatgi, R 2002, *Basic International Taxation*, Kluwer Law International.