

Taxation – Lecture 1

FUNDAMENTALS OF INTERNATIONAL TAXATION

About the course

- Required literature:

- ❑ RADVAN, Michal. Czech Tax Law - 3rd ed. 3. vyd. Brno: Masarykova univerzita, 2010. 65 s. Fac. of Law Publ. no. 4 (Edition of textbooks). ISBN 978-80-210-5269-7.
- ❑ Recent tax policy trends and reforms in OECD countries. Paris: Organisation for Economic Co-operation and Development, 2004. 170 s. ISBN 9264016570.
- ❑ MCGEE, Robert W. The philosophy of taxation and public finance. Boston: Kluwer Academic Publishers, 2004. viii, 313. ISBN 1402077165.

- Recommended literature:

- ❑ OECD/G20 Base Erosion and Profit Shifting Project 2015. Final Reports.
<http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf>

About the course

- Requirements for successful accomplishment of the course:
 - ❑ 85% participation at seminars is required.
 - ❑ 60% of final grade can be received during final exam and 40% of final grade can be received during seminars. 40% is splitted into 2 midterm tests (10%) and 1 presentation (20%) or activity at the seminars (20%).
 - ❑ Minimum required amount of for the midterm test is 60% of correct answers.
 - ❑ Final test is a written exam.

Content

- Fundamentals of taxation
- Tax system and its components
- International tax legislation and its harmonization
- Tax residents and nonresidents
- Tax planning activities of MNCs

- Literature
- Appendix: double agreement of CR

Fundamentals – role of government

- One of the threshold questions one must ask when discussing the role of taxation and public finance is: "**What should government do?**" This question is important because **anything that government does must be paid for by someone**. The more things that government does, the more things that people must pay for. Getting back to the question, the easy answer is that **government should do things that individuals cannot do for themselves**. This argument is basic and pervasive within any society. The problem is that **all services which government provides cost money**. A better question would be: **Should someone do something to alleviate this perceived problem, and if so, who should do it?**
 - **Private sector** - the evidence is clear that the **private sector can do just about anything better and cheaper than the government**. The post office is one of the easiest targets. Where private letter delivery has been tried, it has been found to be faster, more efficient and cheaper. The problem with

Fundamentals – role of government

private delivery is that government arrests anyone who tries to compete against its **first class mail delivery service monopoly** by offering better service at lower cost.

- **Government** – since the private sector can do just about anything better than government, the question then becomes what do we need government for? **Government should fulfill functions that benefit the vast majority of the people: protecting things like property and contract rights, preventing internal violence and fraud by criminals and external violence by foreign armies.** Those are the only functions that benefit the vast majority of the people. **Every other thing that government does protects some special interest, usually at the expense of the general public.**
- **Doing nothing** – perhaps, some things should not be done at all, either by governments or by individuals. To rephrase the argument in clearer terms: Something is not perfect;

Fundamentals – role of government

therefore, somebody has to do something about it. That somebody may be government, but it may also be someone working in the private profit sector or in the nonprofit sector. Or it may be nobody at all. **Just because someone perceives that something is not perfect, it does not follow that anything needs to be done to improve the situation. Sometimes inaction is better than taking action.** That is definitely the case when any action taken will make things worse rather than better. So the argument that something is wrong, therefore someone must do something about it is structurally defective because it omits one possibility – do nothing.

Fundamentals – tax evasion

- **Can tax evasion be ever justified on moral grounds?**
 - **Is taxation a theft?** - Theft is generally defined as the taking of property without the owner's consent. But **when it is some government that does the taking, it is called taxation.** However, there is a difference between taxation and robbery because **robbery is a one-time thing**, whereas **taxation** is something that **occurs at regular intervals**, which makes it more akin to exploitation or slavery.
 - **Is tax evasion always unethical or only sometimes?** - Certainly if **tax evasion is never unethical**, it logically follows that **someone who is guilty of it should not be punished by the profession. But what if it is illegal?** Illegal activities should be punished. Or should they? Is someone who lives in Nazi Germany obligated to follow the laws? People who are unfortunate to live under such regimes might have an ethical obligation to break some laws, at least if the penalty for doing

Fundamentals – tax evasion

so is small or nonexistent. So **it does not follow that individuals act unethically just because they broke some law. It depends on what law they violated, if the law is unjust, then there seems to be no ethical problem with breaking such a law.**

- **Jewish view on ethics of tax evasion** – based on interpretations of the Jewish literature on tax evasion it is possible to conclude **that in most cases tax evasion is unethical, but there are some exceptions.** For example, the state is supposed to be the servant and the people the masters. If and when it gets to the point **when the state starts acting like the master and starts treating the people like servants, perhaps tax evasion is not unethical.**
- **Christian view on ethics of tax evasion** - **Christian writers cannot agree** on whether, and under what circumstances, tax evasion might be unethical: some

Fundamentals – tax evasion

Christian scholars believe that **there is nothing ethically wrong with evading indirect taxes** and others think that **it is ethically improper to evade any tax**, even if the state does evil things with the proceeds.

- **Islam view on ethics of tax evasion** - according to Islam, people have a moral obligation to **pay zakat for the support of the poor and for the legitimate functions of government**. Thus, **evading one's duty to pay zakat is classified as an immoral act**. The Islamic system of taxation is a voluntary one, although Islamic literature makes it clear that **a government is justified in forcing people to pay taxes if the amount raised by zakat is insufficient to cover all the legitimate costs of government**. However, **“This right of interference with the individual's personal property will be limited to the extent required by the general welfare of the society ...”**

Fundamentals – tax evasion

- **Emerging economies view on ethics of tax evasion** – in many emerging economies people do not pay taxes because **of the widespread feeling that the government does not deserve the fruits of people's labor**. There are a variety of reasons why this feeling is so widespread but **the basic reasons** revolve around **corruption and the lack of services**.
- **Is aiding and abetting tax evasion illegal?** – If there is **nothing ethically wrong with tax evasion**, it seems to follow that **attorneys, accountants and financial planners should not be penalized for advising their clients to evade taxes**, or even for helping them to evade taxes. Yet it is probably safe to assume that the vast **majority of professional codes of ethics** for attorneys, accountants and financial planners - perhaps all - **would consider any kind of activity that aids in tax evasion to be unethical and subject to sanction**.

Tax system - tax vs. fee

- **Tax** is an obligatory amount with a laid down rate which **is more or less regularly collected from the incomes, value and property** of economic subjects to the public budgets **on the irrecoverable principle**.
- **Fee** is an obligatory **irrecoverable amount** collected by the state or other public corporations **for certain legal acts**.
- **To tell the truth, the difference between “tax” and “fee” is really more theoretical than practical.** For example in a lot of towns the “dog charge” is in fact the “dog tax”: the holders of dogs do not get any plastic bags for the excrements, municipality does not install waste baskets, does not clean pedestrians etc. On the other hand, the “road tax” is rather “road fee” because the whole revenue must be invested by the State Fund of Transport Infrastructure to modernization of existing roads and building new ones.

Tax system - functions of tax

- There are **three functions of tax**:
 - ❑ The **fiscal function** is the most important. Its purpose is to **guarantee the incomes of the state and municipal budgets and other budgets because taxes are the most important incomes for these budgets.**
 - ❑ **Regulation function** is closely connected with fiscal function. **Using taxes, the state can effectively correct the incomes while transferring money between economical subjects and public funds.** A good tax system can affect the effectiveness of economy. But the state must be very careful in tax rates: the tax burden must respect the tax capacity. **Too high taxes do not motivate people to work, to run a business.**
 - ❑ **Stimulation function** means **using tax instruments to impress an economic subject.** It is realized in **using several tax rates that can stimulate the development of some activities or stifle others.**

Tax system - components of tax

- The basic **structural components** are (based on evidence from CR):
 - ❑ **Object of taxation** - is a legally relevant situation described by law that is connected with a tax duty. It is usually obvious what the object of taxation is just from the title of the tax. Incomes, possession or using property, transfers with property, consumption, etc. can be the object of taxation.
 - ❑ **Correction components** - are some possibilities for the taxpayer not to pay the tax or pay less than it is usual. Tax **reduction and exemptions** from taxation are most common.
 - ❑ **Czech tax administration knows two types of taxpayers:**
 - a natural person or legal entity **whose income, property or legal acts (legal transactions) are object of taxation,**
 - a natural person or legal entity **that has responsibility to calculate the tax, collect it or withheld it and transfer it in time to the tax administrator.**

Tax system - components of tax

- ❑ **Tax base - the quantity of the object of taxation.** As the tax base is usually **economic income** (for income taxes), **value** (for VAT, inheritance tax, gift tax, real-estate transfer tax, partly excise taxes), **area** (real-estate tax) or something different (for example combination of weight and number of axles or engine capacity for the road tax).
- ❑ **Tax rate - determines the amount of the tax to the tax base.** Several kinds of tax rate are distinguished:
 - **fixed tax rate - fixed amount** of money **irrespective of the quantity of the tax base,**
 - **percent tax rate - tax includes several percent of the tax base; in CR there are 3 possibilities for percent tax rate:**
 - ✓ **linear tax rate - the same percentage for a different tax base,**
 - ✓ **regressive tax rate - the higher the tax base, the higher the percentage,**

Tax system - components of tax

- ✓ **degressive tax rate - the higher the tax base, the lower the percentage** (this kind of tax rate is not used because of its injustice).
- **Conditions of payment - are usually terms and fundamentals of payment.** Some taxes are paid **in one term**, others can be paid **in several part payments**. Sometimes the taxpayer is obliged to pay **advance payments before he knows his annual tax duty**.
- There are numerous **tax administrators** in CR but most often the tax administrator is the **tax office**. In other situation **taxes can be administrated by other public administration bodies, by courts or by customs offices**. The most important task for a tax administrator is to make everything so that all the taxes will be collected in time and in the right amount.
- The **budget destination** is very important for all citizens; it means **which of the public funds will get collected money**.

Tax system – DT and inDT

- **Direct tax** is a tax paid **directly by an individual or organization to the imposing entity**. A taxpayer pays a direct tax to a government for different purposes, including real property tax, personal property tax, income tax or taxes on assets. **A direct tax cannot be shifted to another individual or entity**. The individual or organization upon which the tax is levied is responsible for the fulfillment of the tax payment.
- **Indirect tax** is a tax that **increases the price of a good so that consumers are actually paying the tax by paying more for the products**. An indirect tax is most often thought of as a tax that is shifted from one taxpayer to another. Indirect taxes can also be defined as fees that are levied equally upon taxpayers, no matter their income. This is a primary reason why they are thought of as **taxes that are passed on, as the price of the tax is compensated for by simply increasing the overall price of the good or service**. Some economists argue that indirect taxes lead to an inefficient marketplace and alter market prices that don't match their equilibrium.

International tax legislation

- **First tax provisions could be find in articles 95 – 98 (99 with effect from July 1, 1987 in Single European Act) of Treaty of establishing The European Community.**
- Some tax provisions were changed during the years. **The most significant ones were:**
 - **The Treaty of the European Union (92/C 191/01) in Maastricht.**
 - **The Treaty of Amsterdam (97/C 340/01).**
- Tax harmonization in Treaty of establishing the European Community is supported by Articles 94-97 (new numbering), which converges legislation.
- Basic tax provisions were not substantively affected by Treaty of Lisbon (2007/C 306/01) December 13, 2007 with effect from December 1, 2009.

Harmonization - DT and inDT

- **Highly divergent direct tax rates across Europe have raised questions about the limits of national sovereignty over direct taxes and the need to harmonize corporate taxes.**
- The new wave of flat tax regimes, implemented by some of the new EU Member States, has intensified **the necessity of corporate tax base harmonization.**
- **Decreasing direct tax rates have attracted more investors to these countries even if the tax regime is not the only factor for such a decision.**
- For the first major step in harmonization of direct taxes can be considered the acceptance of **Arm's length Standard (ALS) in 1963.**
- A major breakthrough in deepening cooperation between Member States caused **Directive 77/799/EEC, which introduced a mandatory exchange of information on the main direct taxes.**

Harmonization - DT

- **The new Directive 2011/16/EU:**
 - ❑ is valid from January 1, 2013 and repeals directive 77/799/EEC.
 - ❑ from 2015, it **orders reciprocal exchange of all available information concerning majority of income.**
 - ❑ **applies to all taxes and insurances other than VAT and excise duties.**
- **Directive 2010/24/EU**, which is valid from January 1, 2012 contains recovery of claims.
- In the year 1990 was signed **Convention on the elimination of double taxation in connection with adjustment of profits of associated enterprises** (90/436/EEC), which is valid from year 1995 and **sets out principles and methods on how to avoid double taxation.** The validity of Convention 90/436/EEC is always automatically renewed after 5 years. From 1993 for easier information tax identification number is being used.

Harmonization - inDT

- **The first Council Directive 67/227/EEC** on the harmonization of legislation of Member States concerning turnover taxes was accepted April 11, 1967. This Directive **defines the value added tax as a general turnover tax on consumption specified by percentage of selling price.**
- **Second Council Directive 67/228/EEC** defines the subject of VAT and defines the basic components such as: **place of taxation, the national territory, the supply of goods and services and taxable person.** Latter this Directive was replaced by Directive 2006/112/EC on the common system of VAT with effect.
- **Sixth Directive 77/388/EEC** is deepening harmonization of VAT and **eliminates taxation of imports.**
- **Directive 92/12/EEC** was crucial for harmonization of excise duties. Directive laid down a **general scheme for collection of taxes, adjusted the production, processing, holding and movement of products subjected to excise duty.**

Harmonization - inDT

- **Directive 2008/118/EC on general arrangements for excise duties has replaced Directive 92/12/EEC.** Excise duties: Mineral oils, Alcohol, Tobacco products, Energy products etc.

Tax residents and nonresidents

(Based on evidence from CR)

- **Tax residents – natural persons with a residential address in the CR or individuals who usually stay in CR (it means for at least 183 days in the relevant calendar year, either continuously or intermittently), these persons are liable to tax on income arising from sources in both CR and abroad.**
- **Tax non-residents – natural persons not mentioned above as tax residents, students from abroad or patients staying in CR for the purpose of medical treatment, they are liable to tax incomes arising only from sources in the Czech Republic.**

Tax planning activity of MNCs – tax planning

- **The debate -**

- In recent years, the international tax planning strategies of multinationals have become a source of international debate: **What is the international tax planning debate about? Who are the key players?** And importantly: **what do companies actually do when they engage in international tax planning?** The debate in international tax law has largely focused on **the tax-paying morale of multinationals.**
- Over the years countries worldwide have been taken **legislative actions to reduce the international tax planning opportunities for multinationals as tax planning can significantly reduce tax revenues for countries.** Sometimes, countries undertook such action on their own, other times, they work together internationally.
- The fast pace in which **globalization of multinationals** is taking place, and the growth of **the digital economy** have

Tax plan-g activity of MNCs – tax plan-g

increased the possibilities for multinationals to engage in tax planning activities. The debate regarding the tax morale of multinationals, with the intensity and with the emotion that it has now, **came to full force when the recent financial crisis hit national economies.**

- Recently, fueled by the momentum created by the financial crisis, **the work of the EU** and in particular, **the OECD's work on addressing aggressive tax planning has taken flight at the request of the G20. On July 19, 2013, the OECD released an action plan, identifying 15 action points to address what the OECD calls Base Erosion and Profit Shifting, or BEPS, that is addressing the tax reduction strategies of multinationals.** Since that time the OECD has been working continuously with member, non-member countries, and other stakeholders to develop the 15 action points into international tax law changes that can be jointly implemented by countries worldwide.

Tax planning activity of MNCs – tax planning

- **OECD –**

- ❑ **As the end of the 19th century and the beginning of the 20th century saw an uprise in post-war economic activity, the issue of international juridical double taxation became more pressing. Consequently, individual states entered into bilateral agreements for the avoidance of double taxation. First bilateral treaties were concluded on a relatively small scale between neighboring countries.**
- ❑ **After the First World War an extensive treaty network developed in central Europe (e.g. Germany-Italy, 1925; UK-Ireland, 1922; USA-Sweden and USA-France, 1939). This patchwork of differing bilateral treaties stimulated the League of Nations (predecessor of UNO) to develop a kind of uniform, model tax treaty. In 1921, it asked four experts on public finance (Rotterdam, Turin, New York, and London) to prepare a report of double taxation which led to a famous**

Tax planning activity of MNCs – tax planning

publication. This publication became a foundation for the **first model treaty in 1928** and for the model treaty of Mexico in 1943. In 1946, the model treaty of London was completed.

- ❑ **After the Second World War the work on the model tax treaties was continued by the Organization of European Economic Cooperation (OEEC) and its successor organization, the OECD. In 1963 this led to a complete model tax treaty. In an official recommendation the council of the OECD recommended its member states to use this model and commentary as a basis for their bilateral tax treaty negotiations..**
- ❑ **In 1992 the Model Tax Convention was published in a loose leaf format and the impact of the OECD's Model Tax Convention has extended far beyond the OECD area. It has been used as a reference document in negotiations between OECD member countries, between OECD member**

Tax planning activity of MNCs – tax planning

countries and non-member countries, and even between non-member countries. Also, the subsequently developed by UN Model Double Taxation Convention between developed and developing countries has been influenced greatly by the OECD model.

- **BEPS –**

- The work of the OECD on BEPS started with the G20 Finance Ministers Meeting in Mexico in 2012. In 2013, the OECD released a **report addressing base erosion in profit shifting, identifying six key areas of concern:**
 - **Mismatches in entity and instrument characterization.** For example, where an instrument is created which **generates deductible payments in one country, while the payments are treated as non-taxable receipts in the hands of the recipient in another country.**
 - **Taxing profits from the delivery of digital goods and**

Tax planning activity of MNCs – tax planning

- **services.** For example, in the **situation where a company's selling on the internet generates huge sales in a country, but does not have any taxable presence**, for example, under the current taxing principles.
- **Intra-group debt financing and captive insurance.** Notably, where **interest deductions erode the tax basis in a high-tax jurisdiction, while the receipts are taxed in the hands of a related party in a low-tax jurisdiction.**
- **Transfer pricing.** For example, **regulates to determining the value of creation of intangibles.**
- **Anti-avoidance measures.**
- **Harmful preferential regimes, or tax havens and preferential selective regimes** in countries attracting investment away from countries with an ordinary tax system.

Tax planning activity of MNCs – tax planning

- ❑ Following up on that report, on July 19, 2013, the OECD **released an action plan, breaking down the key areas into 15 action points.** Since that time, the OECD has been working continuously, publishing additional reports, requesting public and expert feedback, et cetera, to meet its self-imposed deadline of completing the work on the action items.
- ❑ **Problem with BEPS problem itself** - Obviously the OECD views base erosion and profit shifting as a serious risk. In this respect the OECD has said that **BEPS is a risk to tax revenues, tax sovereignty, and tax fairness for OECD member countries and nonmembers alike.** In particular, the following consequences of BEPS worry the OECD:
 - **The question of fairness** - Taxes paid in a country are used to provide services to its residents (for example, healthcare, education etc.). **If multinationals do not contribute their fair share in taxes, the service level of the government decreases, or residents**

Tax planning activity of MNCs – tax planning

need to pick up the tab. As a result, BEPS can also negatively impact tax compliance of individuals who will be reluctant to pay taxes where international companies can easily avoid them.

- **BEPS can distort competition - Companies that operate in more than one country may benefit from the rules of international tax law giving them a competitive advantage over companies that do business in one country only. and cannot use these rules.**
- From an economic perspective **BEPS can distort investment decisions, where companies choose to do business** based on tax rather than genuine business considerations.

Tax planning activity of MNCs – transfer pricing

- **Transfer pricing (TP) –**
 - ❑ **A transfer price is what one unit of a business charges another unit of the same business for a good or service. The transfer price is usually close to the prevailing market rate when different divisions of the same business are evaluated separately for profit and loss. Transfer pricing may thus be used to shift income from one country to another. This can be avoided by use of arm's length principle which is the international standard adopted by the OECD and by many countries worldwide.**
- **The arm's length principle (ALP) -**
 - ❑ **ALP is the condition or the fact that the parties to a transaction are independent and on an equal footing. It is used specifically in contract law to arrange an equitable agreement that will stand up to legal scrutiny, even though the parties may have shared interests (e.g., employer-employee) or are too closely**

Tax planning activity of MNCs – transfer pricing

related to be seen as completely independent (e.g., the parties have familial ties). What does ALP mean? When conditions are made or imposed between the two enterprises in their commercial or financial relation which differ from those which would be made between independent enterprises, then any profit which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of the enterprise and taxed accordingly. **ALP is, therefore, based on the comparison between the terms and conditions set in the intra-group transaction with the conditions that independent parties would have entered into under comparable circumstances.**

- ❑ The OECD transfer pricing guidelines provide the internationally agreed **principles for the application of ALP. ALP applies to all forms of intra-group transactions, from the sale of goods and provision of services**

Tax planning activity of MNCs – transfer pricing

to business restructuring. Comparability is the core of the application of ALP:

- **A comparable transaction must occur between independent parties.** This means that in many cases, a competitor cannot represent a comparable.
- **Comparability exists only if there are no differences liable to affect economic conditions. Where such differences exist, two transactions can be comparable only if reliable adjustments can be made.** Reference is made to internal comparability when a transaction's similar to the intra-group transaction takes place between one of the parties involved in the intra-group transaction and a third party. For example, Prada sells bags to its related distributors, and at the same time, sells the same bags to independent distributor under comparable circumstances. Reference is in turn made to

Tax planning activity of MNCs – transfer pricing

external comparability, when the comparable transaction takes place between two independent parties, none of which is part of the intra-group transaction under review. For example, where two group entities enter into a transaction, the object of which is a commodity, the listing price of such a commodity represents an external comparable. The OECD guidelines identify **five main comparability factors that has to be taken into account:**

- ✓ **characteristics of property of services**
- ✓ **functional analysis**
- ✓ **contractual terms**
- ✓ **economic circumstances and business strategies.**

The extent to which each of these factors matters in establishing comparability will depend upon the nature of the transaction under review, and upon the transfer pricing method adopted.

Appendix: double agreements of CR

- **Czech Republic is the signatory to a treaty for the Prevention of Double Taxation** with many countries all over the world, not only in Europe.
- Every double taxation prevention treaty uses one or more of the **methods of double taxation prevention**:
 - ❑ **Full exemption** – income liable to tax in abroad is not liable to tax in the Czech Republic
 - ❑ **Exemption with progression** – income liable to tax in abroad is not liable to tax in Czech Republic but the taxpayer must use the tax rate for both incomes from abroad and from the Czech Republic.
 - ❑ **Full credit** – all the taxpayer's incomes are liable to tax in the Czech Republic and from the final tax can the taxpayer deduct the tax paid in abroad.
 - ❑ **Ordinary credit** – both the taxpayer's incomes from abroad and from Czech Republic are liable to tax in the Czech Republic.

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