

CHAPTER III

TAXING PORTFOLIO INCOME THE UNGLOBALIZED INTERNATIONAL TAX ARSENAL

In this chapter I survey the means used by countries to implement their tax choices with respect to cross-border portfolio capital income. As noted in the previous chapter, current tax theory leaves countries a broad spectrum of choices with respect to capital taxation generally and specifically with respect to the taxation of portfolio capital income. The main choices include residence-versus source-based taxation of residents, deferral of tax on foreign-source income or current taxation thereof, and taxing foreigners on their portfolio income versus exempting them from tax. Each choice is measured by its efficiency, equity and administrability, and, as chapter II has shown, almost any such policy choice can be justified under these general criteria if the adequate perspective is adopted.

Whatever the ultimate tax choice made, it needs to be implemented using mechanisms that are, as of today, mainly unilateral or bilateral. The first two parts of this chapter present the unilateral and bilateral tax "tools of the trade" and their functioning in the globalized capital markets setting described in chapter I. The third part of this chapter examines an additional, relatively neglected, path – multilateral cooperation – and presents several initiatives in that direction.

1. The tools of the trade: unilateral means

The first set of tax mechanisms reviewed herein is the one employed by a country unilaterally. Most countries opt to tax income arising in their jurisdiction (source taxation). In addition, some countries opt to tax their residents on their worldwide income (residence taxation), at least with respect to portfolio capital income. The mechanisms used to achieve each of these goals are discussed herein, along with an assessment of their efficacy in today's economic environment.

1.1. Source-based taxation of foreigners' portfolio investment

Most countries impose tax on income derived by non-residents in their jurisdiction, be it income from business operations, passive income from investment or capital gains. This work focuses on portfolio investment and accordingly this part presents the main mechanism used by countries to tax portfolio income (dividends, interest and capital gains) – the withholding tax.

1.1.1. The reference case: taxation of residents' domestic portfolio investment

The taxation of portfolio income in a purely domestic case, i.e. a resident deriving portfolio income from a domestic investment, will serve as a reference to which

the taxation of foreigners can be compared. For this purpose, the following provides a succinct description of the common tax rules applicable to such domestic case.

Most tax systems differentiate between active (business) and passive income receipts. In several countries both categories are subject to the same tax rate schedules and aggregated for purposes of determining the taxpayer's taxable income and applicable tax rate, but the distinction may be of relevance in auxiliary provisions such as carry-back and carry-forward of losses or deductible expenses ¹.

Other countries subject the two categories to different schedules of tax rate ².

Another common distinction is made between ordinary income (including both active and passive income, as discussed above) and capital gains. The latter are either exempt from tax altogether ³ or are subject to tax at rates substantially lower than the ones applicable to ordinary income ⁴.

Within the passive income category, not all types of income are treated alike. Interest payments are generally deductible by the paying corporation, but dividends are not, resulting in two levels of tax on the return to equity (i.e. the corporate-level tax on its income and the shareholder-level tax on the dividend). Countries have developed various mechanisms aimed at reducing this double (or multiple) taxation of dividends, ranging from no relief (the so-called "classical system" ⁵) to full integration by allowing the corporation to deduct the dividend payment, subjecting distributed income to lower tax rates than retained income, allowing the taxpayer a credit against her own tax liability for the tax paid by the corporation or exempting the dividend from tax at the hands of the shareholder ⁶.

¹ In the Israeli Income Tax Ordinance (ITO), for example, §928 allows business losses to be carried forward indefinitely, but the same can only be set-off against business income in future years.

² The Nordic countries, for example, subject capital income to tax at a flat rate, while other income (personal income) is taxed at progressive rates. In other countries (e.g. Belgium, Italy and Japan) a withholding tax is imposed on capital income payments and the taxpayer can choose to treat the tax withheld as the final liability or add the income to her overall taxable income and credit the tax withheld against it. See Organisation for Economic Cooperation and Development, "Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions", Paris: OECD (1999) (hereinafter: OECD CIVs Report), at 29-30.

³ In the Netherlands, for example, capital gains derived by individuals are generally exempt from tax, except for gains derived from a disposition in a "substantial interest" in a company. See Van Raad, 973 T.M., "Business Operations in the Netherlands", Tax Management Foreign Income Portfolios (2000).

⁴ See e.g. US Internal Revenue Code §1(h).

⁵ Note that even in countries adhering to the "classical system", such as the United States, multiple taxation that may result as dividends flow up the corporate chain until the individual shareholder is alleviated by exempting inter-company dividends from tax, in whole or in part. See I.R.C. §243 (providing partial exemption based on the parent corporation's level of holding in the subsidiary); Israeli ITO §126(b) (excluding inter-company dividends from the recipient company's taxable income).

⁶ See OECD CIVs Report at 32-33. Partial integration can be effected by subjecting the dividends to a lower rate of tax than that applicable to other types of income. See e.g. Israeli Tax Ordinance, §125B.

The existence of three distinct tax regimes for capital income – dividends, interest and capital gains – has been fueling tax planning and financial innovation for several decades. With the increased sophistication of financial markets' participants, the distortions created by the need to categorize and tag each flow have increased, and the discussion regarding the proper remedy intensified. The discussion regarding the domestic implications of financial innovation is beyond the scope of this work, however several features of the debate have international implications and are discussed below ⁷.

The treatment of collective investment vehicles

Given the importance in modern financial markets of non-bank financial intermediaries, of which collective investment vehicles (e.g. mutual funds and pension funds, hereinafter: CIVs) are a material part ⁸, and the fact that they serve as close substitutes to direct portfolio investment by budget-surplus units, their taxation will also be considered herein. Similar to the case of direct investment, the following first provides a brief overview of the tax implications in a purely domestic case.

In most countries, the policy objective concerning the taxation of CIVs is to achieve neutrality between the total tax burden on investment through them and the tax burden on direct investment in the underlying securities ⁹. To achieve such neutrality, countries adopt one of five typical models of CIV taxation ¹⁰:

- the fund may be disregarded as a taxable entity, similar to the treatment of partnerships for tax purposes;
- the fund may be recognized as a taxable entity, but be wholly exempt from tax if it fulfills certain conditions;
- the fund may be subject to tax but on a specially defined tax base. Most commonly, distributions to unit holders are allowed as a deduction from the fund's taxable income, as is the case in, e.g. the United States ¹¹, the United Kingdom ¹² and Canada;

⁷ . For a discussion of the issues in the domestic context, see e.g. Alvin C. Warren, "Financial Contract Innovation and Income Tax Policy", 107 Har. L. Rev. 460; and Scott M. Colbrenner, "Derivatives Design and Taxation". 15 Va. Tax Rev. (Fall 1995) 211.

⁸ See chapter I, section 1.3.1., for a discussion of the growing importance of non-bank intermediaries such as collective investment vehicles in financial markets.

⁹ See OECD CIVs Report at 48-49.

¹⁰ See Lynne J. Ed and Dr. Paul J.M. Bongaarts, "The Taxation of Investment Funds: General Report", International Fiscal Association, Cahiers de Droit Fiscal International Vol. LXXXIIb (1997). 38-39.

¹¹ This applies to Regulated Investment Companies (RICs), the taxation of which is governed by the rules in US I.R.C. §§851-855. Other forms of CIVs are subject to different treatment. Real Estate Mortgage Investment Conduits (REMICs), for example, are disregarded as taxable entities. See US I.R.C. §860AS.

- the fund may be subject to an entity-level tax at a reduced rate;
- the fund may be fully taxed but the distributions are exempt in the hands of the unit holders (as is the case in Israel) or alternatively a form of integration of entity-level and shareholder-level taxes (as discussed above) is allowed. This is the case in New Zealand and Norway, for example.

The OECD Report shows that all these various alternatives, as in fact implemented in the legislation of OECD countries, achieve a high level of neutrality between domestic direct portfolio investment and domestic investment through a CIV, in accordance with the general policy goal mentioned above¹³. When a cross-border element (a foreign unit-holder, a foreign CIV, investment in foreign securities or any combination of the above) is imposed on these regimes the results change markedly, as further discussed below.

¹² This applies to Authorized Unit Trusts, whereas other types of CIVs are subject to other forms of taxation. See Conor Hurley, "The Taxation of Investment Funds: United Kingdom Report", International Fiscal Association. Cahiers de Droit Fiscal International Vol. LXXXIIb (1997), at 830-833.

¹³ See OECD CIVs Report at 75-76.