The Impact of State Sovereignty on Global Trade and International Taxation

by

Ramon J. Jeffery
B.A., LL.B. (Hons.) (Monash), LL.M. (LSE), Ph.D. (Cantab.)

Series on International Taxation: No 23

KLUWER LAW INTERNATIONAL
THE HAGUE - LONDON - BOSTON
# Table of Contents

Preface ................................................................................................................................. ix
Table of Cases ...................................................................................................................... xix
Abbreviations ....................................................................................................................... xxi

Introduction .............................................................................................................................. 1

**Chapter 1: INTERNATIONAL DIRECT TAX DISTORTIONS AND THE GLOBAL ECONOMY** ................................................................. 3

1.1 Introduction ...................................................................................................................... 3

1.2 International Direct Tax Distortions: Tax Neutrality and Equity .... 3
   1.2.1 Tax Neutrality ........................................................................................................... 4
      1.2.1.1 The Meaning of Neutrality .............................................................................. 4
      1.2.1.2 Inherent Distortions Arising from the Interaction of National Tax Systems ......................................................................................................................... 5
      1.2.1.3 Different Approaches to Neutrality: Absolute or Relative Neutrality? ........... 5
         1.2.1.3.(a) Neutrality as an Unattainable Ideal and the Paradigm of Capital Export and Capital Import Neutrality ......................................................... 5
         1.2.1.3.(b) Neutrality as an Indivisible Concept: the View of Vogel ....................... 7
         1.2.1.3.(c) Relative Neutrality .................................................................................... 8
   1.2.2 Tax Equity .................................................................................................................. 10
      1.2.2.1 Taxpayer Equity .............................................................................................. 10
      1.2.2.2 Inter-Nations Equity ...................................................................................... 11
   1.2.3 The Interaction of Equity and Neutrality Considerations ......... 12
      1.2.3.1 The Path of Least Time and Least Action ...................................................... 12

1.3 The Nexus Between the Elimination of International Direct Tax Distortions and Global Economic Change................................................... 13
CONTENTS

1.4 Global Economic Change ......................................................... 15
  1.4.1 The Evolution from Economic Nationalism to International Economic Integration ........................................... 15
  1.4.2 Discontinuities in the Rate and Extent of International Economic Integration .............................................. 19
  1.4.3 The Role and Position of the State in the Global Economy
    1.4.3.1 States at the Cross Roads: The Duality of Choice Principle .............................................................. 20
    1.4.3.2 The Reluctance of States to Cede or Restrict their Sovereignty ......................................................... 21
  1.4.4 Conclusion ........................................................................ 23

Chapter 2 SOVEREIGNTY AND JURISDICTION ................................ 25

2.1 Introduction ............................................................................ 25

2.2 The Meaning of Sovereignty and Jurisdiction ............................... 25
  2.2.1 Introduction ..................................................................... 25
  2.2.2 Sovereignty and Jurisdiction Defined ................................. 26

2.3 The Sources of International Law .............................................. 27
  2.3.1 Customary International Law ............................................. 28
    2.3.1.1 Factors in the Formation of Custom ............................. 29
      2.3.1.1.(a) Uniformity and Consistency of the Practice ......... 29
      2.3.1.1.(b) Duration .......................................................... 29
      2.3.1.1.(c) Generality of the Practice ................................. 29
      2.3.1.1.(d) Opinio Juris .................................................... 29
      2.3.1.1.(e) Persistent Objection ........................................ 30
    2.3.1.2 Jurisdiction: the Positivist School and the Presumption of Absolute Freedom of State Power ......... 30
    2.3.1.3 Conclusion .................................................................. 31
  2.3.2 Treaties ............................................................................. 31

2.3.3 The Dynamics Between Treaty and Custom ............................... 32
  2.3.3.1 The Hierarchy Between Treaty and Custom ........................ 33
  2.3.3.2 Double Tax Agreements and Customary International Law ......................................................... 34

2.3.4 The A Priori Approach to International Law ............................ 35

2.4 The Relationship Between International Law and National Law ...... 36
  2.4.1 The ‘Dialectical Puzzle’ of the Co-existence of the Law of Nations and State Sovereignty ................................. 36
  2.4.2 State Freedom of Action and the Reserved Domain of Domestic Jurisdiction ........................................... 37
  2.4.3 Characterisation .................................................................. 39
  2.4.4 The Reception of International Law into National Law ........ 40
    2.4.4.1 Monism Versus Dualism ......................................... 40
    2.4.4.2 An Alternative Theory: National and International Law Running in Parallel ............................. 40
2.4.4.3 State Acceptance of International Law.......................... 41
2.4.4.4 Conclusion...................................................... 42

2.5 Legislative Jurisdiction Under Customary International Law .... 42
  2.5.1 Is there Unlimited Fiscal Jurisdiction?......................... 43
  2.5.2 The Traditional Approach to Establishing Jurisdiction ....... 44
    2.5.2.1 The Territorial Basis of Jurisdiction .................. 44
      2.5.2.1.(a) Fiscal Residence .................................. 45
      2.5.2.1.(b) Sovereign Immunity ............................... 46
      2.5.2.1.(c) Evaluation of the Territorial Basis of Jurisdiction ................. 48
    2.5.2.2 The Personal Bases of Jurisdiction .................... 49
      2.5.2.2.(a) Nationality ....................................... 49
      2.5.2.2.(b) Domicile ......................................... 50
  2.5.3 The Need for Reform as Illustrated by the Operation of the Effects Doctrine in Anti-Trust Jurisdiction .................. 51
  2.5.4 An Approach to Jurisdiction Based on Reasonableness ........ 52
  2.5.5 Jurisdiction to Prescribe Versus Jurisdiction to Apply ....... 56

2.6 Consequences Flowing from the Exercise of Jurisdiction ......... 56
  2.6.1 Illegal Exercise of Jurisdiction ........................................ 57
  2.6.2 Concurrence of Jurisdiction ...................................... 58

2.7 Conclusion ................................................................... 58

Chapter 3 INTERNATIONAL TAX NON-DISCRIMINATION ...... 61

3.1 Introduction .................................................................. 61
  3.1.1 The Meaning of International Tax Discrimination .............. 61
  3.1.2 How International Tax Discrimination Gives Rise to Direct Tax Distortions ......................................................... 62

3.2 Non-Discrimination in the International Tax Treaty Context: Article 24 of the OECD Model ........................................ 63
  3.2.1 Introduction ................................................................ 63
  3.2.2 Outline of Article 24 .................................................. 63
  3.2.3 Article 24(1): the Nationality Provision ....................... 64
      3.2.3.1 The Declining Relevance of Nationality as a Criterion for Differentiation ......................................................... 65
      3.2.3.2 Who is a National? ......................................... 66
      3.2.3.3 The Relationship Between Nationality as a Criterion for Non-Discrimination and as a Criterion for the Exercise of Fiscal Jurisdiction ......................................................... 67
      3.2.3.4 ‘In the Same Circumstances’ ................................ 67
  3.2.4 Article 24(3): the Permanent Establishment Provision ....... 69
  3.2.5 Article 24(4): the Equal Deductibility Provision and Article 24(5): the Non-Residential Ownership Provision ................... 71
  3.2.6 Other Criticisms ..................................................... 72
  3.2.7 Conclusion .................................................................. 73
CONTENTS

3.3 Non-Discrimination in the EC Tax Context ........................................... 73
  3.3.1 Introduction ......................................................................................... 73
  3.3.2 The Foundation of the Principle: the Fundamental Freedoms Enshrined in the EC Treaty ................................................................. 75
  3.3.3 The Evolution of the Principle: the Case Law of the ECJ ....... 77
    3.3.3.1 Frontier Worker Situations: the Virtual Resident ... 77
      3.3.3.1.(a) The Wielockx Case ......................................................... 77
      3.3.3.1.(b) The Schumaker Case .................................................... 78
    3.3.3.2 Transitional Situations: the Straddling of the Tax Year .......................................................... 80
      3.3.3.2.(a) The Bachmann Case ...................................................... 80
      3.3.3.2.(a).(i) The Cohesion of the Tax System............................ 81
      3.3.3.2.(b) The Biehl Case .............................................................. 82
    3.3.3.3 The Permanent Establishment Situation ..................... 83
      3.3.3.3.(a) The ‘Avoir Fiscal’ Case ................................................ 83
    3.3.3.4 Discrimination Against One’s Own Nationals? ...... 84
      3.3.3.4.(a) The Asscher Case .......................................................... 84
  3.3.4 Implications of the Principle: the Centrality of Sovereignty and Jurisdiction ............................................................................... 86
    3.3.4.1 A Balancing Principle ............................................................ 86
    3.3.4.2 The Same Circumstances Requirement: the Need for an International Perspective .......................................................... 88
      3.3.4.2.(a) The Effects of a Foreign Tax Credit System ............ 88
      3.3.4.2.(b) The Adoption of a Source Basis of Taxation? .......... 89
    3.3.4.3 The Relationship Between Negative and Positive Integration .......................................................... 90
    3.3.4.4 The Enforceability of the Prohibition by Taxpayers .......... 90
    3.3.4.5 Conclusion .................................................................................. 91
  3.3.5 The Relationship Between the EC and International Tax Non-Discrimination Principles .......................................................... 91
    3.3.5.1 The Overlap Between the EC and International Tax Treaty Non-Discrimination Principles ............................................. 91
    3.3.5.2 The Influence of Double Tax Treaties in the Formulation of the EC Tax Non-Discrimination Principle .......................................................... 93
    3.3.5.3 Conclusions ............................................................................... 95
  3.4 Conclusion ............................................................................................. 95

Chapter 4 TREATY SHOPPING AND THE EXTRA-TERRITORIAL ENFORCEMENT OF REVENUE LAWS: PROBLEMS OF INTERNATIONAL TAX EVASION AND AVOIDANCE ........................................... 97
## CONTENTS

4.1 Introduction ........................................................................................................... 97

4.2 International Tax Evasion and Avoidance ......................................................... 97

4.3 Treaty Shopping and the Applicability of Domestic Anti-Avoidance Measures ................................................................. 99

4.3.1 Introduction ........................................................................................................ 99

4.3.2 The Nature of Treaty Shopping ........................................................................ 99

4.3.3 International Direct Tax Distortions Associated with Treaty Shopping ................. 101

4.3.4 Measures to Combat Perceived Abuses of Treaty Shopping ....................... 102

4.3.5 The Existence of an International Anti-Avoidance Standard ....................... 103

4.3.6 The Application of Domestic Anti-Abuse Measures Under the Treaty ........... 104

4.3.6.1 The Role of Sovereignty and Jurisdiction in Terms of the International Law-Making Process ......................................................... 104

4.3.6.2 Principles of Treaty Interpretation: Article 3(2) of the OECD Model and Articles 31-33 of the Vienna Convention on the Law of Treaties ......... 106

4.3.6.2.(a) “Unless the Context Otherwise Requires” ........................................ 108

4.3.6.2.(b) The Ambulatory Versus the Static Approach to Interpretation .......... 109

4.3.6.2.(c) Application of the Principles of Interpretation to Treaty Shopping .... 111

4.3.6.3 Conclusion ..................................................................................................... 112

4.3.7 Possible Solutions ............................................................................................... 113

4.3.7.1 The Application of Domestic Anti-Abuse Measures: the Integrity of Treaties and the Creation of Direct Tax Distortions ................................. 113

4.3.7.2 The Need for a Treaty Based International Anti-Avoidance Standard .......... 114

4.4 The Extra-Territorial Enforcement of Revenue Laws ....................................... 117

4.4.1 The Nature of the Rule ..................................................................................... 118

4.4.1.1 The Rule as an Aspect of Enforcement Jurisdiction and its Relationship with Legislative Jurisdiction .................................................. 118

4.4.1.2 Origin, Scope and Character of the Rule ................................................. 119

4.4.1.2.(a) The Cases ....................................................................................... 119

4.4.1.2.(b) Scope .............................................................................................. 120

4.4.1.2.(c) Character of the Rule ....................................................................... 121

4.4.1.3 Derogations .............................................................................................. 121

4.4.1.4 Rationale ............................................................................................... 122

4.4.2 Problems with the Rule .................................................................................. 123

4.4.2.1 The Relevance of Developments in the Global Economy and Direct Tax Distortions Associated with the Rule .................................................. 123

4.4.2.2 Other Problems with the Rule .................................................................. 125
CONTENTS

4.4.2.2.(a) The Need to Take Further Account of the Rule's Relationship with Legislative Jurisdiction ........................................... 125
4.4.2.2.(b) The Public Versus Private Rights Distinction .................................. 125
4.4.2.3 Conclusion: the Need for a Re-Assessment of the Rule .................................................. 126

4.4.3 Provisions for the Extra-Territorial Enforcement of Revenue Laws ................................................................. 127
4.4.3.1 Existing Treaty Based Provisions for the Enforcement of Foreign Revenue Laws ................................................ 127
4.4.3.2 A New OECD Model Article Providing for Enforcement .................................................. 129

4.4.4 Conclusion .................................................................................................................. 131

Chapter 5 THE NEED FOR TAX CO-ORDINATION: THE RELATIONS OF THE EUROPEAN COMMUNITY AND MEMBER STATES WITH THE REST OF THE WORLD ........................................................................... 133

5.1 Introduction .................................................................................................................. 133

5.2 Internal Community Tax Measures: The Community-Member State Axis of Relationship ................................................................. 136
5.2.1 Background to the Ruding Recommendations ......................................................... 136
5.2.2 The Principle of Subsidiarity in the Context of the Ruding Proposals .................................................. 137
5.2.2.1 Introduction ........................................................................................................ 137
5.2.2.2 The Principle of Subsidiarity .............................................................................. 138
5.2.2.3 How Subsidiarity has Affected the Committee's Work ........................................ 141
5.2.2.4 Conclusion ........................................................................................................ 143

5.3 The Introduction of Extraneous Direct Tax Distortions Along the Member State-Third Country Axis of Relationship ................................................................. 143
5.3.1 Withholding Tax Provisions in Tax Treaties ........................................................... 144
5.3.2 US Limitation of Benefit Provisions ....................................................................... 144

5.4 The Elimination of Extraneous Direct Tax Distortions: The Community-Third Country and the Community-Member State Axes of Relationship ................................................................. 145
5.4.1 Introduction ............................................................................................................ 145
5.4.2 Theory and Nature of the Community and of the Relationship Between the Community, Third Countries and Member States ................................................................. 146
5.4.3 The Treaty-Making Power of the Community with Third Countries ........................................ 148
5.4.3.1 Relationship with Differences in the Rate andExtent of International Economic Integration ........................................ 148
CONTENTS

5.4.3.2 Lack of Member State External Relations
    Competence Distinguished from Non-Compliance
    with Internal EC Measures ........................................ 149

5.4.3.3 The Implications of the Community’s Implied
    External Relations Power on Member State
    Competence to Enter into Tax Treaties with Third
    Countries .................................................................. 149

5.4.3.4 The Competence of Member States to Enter into
    Dividend and Limitation of Benefits Articles in Tax
    Treaties with Third Countries .................................... 153

5.4.4 Compatibility of Member State–Third Country LOB
    Provisions with Internal EC Measures ......................... 155

5.4.5 Consequences of Community Competence in Tax
    Relationships with Third Countries for Both Community and
    Member State Tax Relations with Such Countries ........... 157

5.4.5.1 Existing Treaties ............................................... 157
    5.4.5.1.(a) EC Law Perspective .................................... 158
    5.4.5.1.(b) International Law Perspective ....................... 159

5.4.5.2 New Treaties ................................................... 160
    5.4.5.2.(a) Theory ...................................................... 160
    5.4.5.2.(b) Practical Alternatives .................................. 161

5.4.6 The Relationship Between Treaty Override and Breach of
    Treaty ....................................................................... 164

5.4.6.1 Breach of Treaty ............................................... 164
    5.4.6.1.(a) The Law of Treaties .................................... 164
    5.4.6.1.(b) The Law of State Responsibility .................... 165
    5.4.6.1.(c) Conclusion .................................................. 165

5.4.6.2 Treaty Override and Breach of Treaty: a Practical
    Example ..................................................................... 165

5.5 Conclusion ............................................................. 167

Chapter 6 CONCLUSION ...................................................... 169

6.1 International Direct Tax Distortions and the Global Economy .... 169

6.2 Sovereignty and Jurisdiction .......................................... 170

6.3 International Tax Non-Discrimination .................................. 171

6.4 Treaty Shopping and the Extra-Territorial Enforcement of Revenue
    Laws ....................................................................... 172

6.5 The Need for Tax Co-Ordination: the Relations of the European
    Community and Member States with the Rest of the World .... 174

6.6 Final Conclusions ...................................................... 175