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Nondiscriminatory Taxation of Foreign Taxpayers – With Special Regard to Deduction of Personal Expenses, Personal Allowances, and Tax Rates

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Nondiscriminatory Taxation of Foreign Taxpayers – With Special Regard to Deduction of Personal Expenses, Personal Allowances, and Tax Rates

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1. Introduction

Nondiscrimination in cross-border taxation has many dimensions. It may pertain to interest deductions for payments to foreign creditors, deductibility of contributions to foreign pension plans, etc.. The areas, however, where nondiscrimination, both under tax treaties and in EC tax law, has received most attention concern less favorable taxation of non-resident taxpayers compared to residents and, to a lesser extent, of foreign versus domestic source income.

This contribution deals with a typical aspect that arises in cross-border taxation of individuals. For tax policy reasons most countries reduce the tax burden of individual taxpayers by taking into account their personal circumstances. In cross-border situations the question arises whether from the perspective of cross-border neutrality this reduction could be applied only by the taxpayer's residence country or whether it should also be granted by the source country. In the latter case, does that necessarily result in an excessive reduction of the combined source and residence country taxes compared to the tax burden borne by a taxpayer who earns the same amount of income from a single country? If yes, is it possible to design a mechanism through which the two countries involved contribute to the tax reduction the combined amount of which is the same that a taxpayer receives with the same overall income derived from his residence country?

2. Business expenses

Since income as a basis for taxation is generally viewed as a net notion, individual income tax systems subject resident and nonresident taxpayers to tax typically on the basis of the net amount of their income, i.e., the gross income they receive reduced by the expenses incurred for earning it (such expenses will be referred to here as "business expenses"). For reasons of efficiency, for particular categories of income resident taxpayers and, more frequently, non-resident taxpayers, however, may instead be subject to tax on the gross amount thereof and at a (relatively low) flat tax rate. The amount of tax so due supposedly approximates the amount that results from the application of regular tax rates to the net amount of the income. In instances where nonresident taxpayers are taxed on a gross income basis while in respect of resident taxpayers a net

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basis is applied, a denial of the deduction of business expenses to nonresident taxpayers may in individual cases result in a higher amount of tax due by them.

It is obvious that in a cross-border neutral tax system nonresident taxpayers should be allowed to be taxed on a net basis[2] and take into account the same types of business expenses as resident taxpayers to determine the amount of income on the basis of which they are taxed. At a different dimension, it should be equally obvious that in respect of foreign source income resident taxpayers should be entitled to the same business deductions as in respect of domestic source income.

3. Personal expense deductions and person-related tax reductions ("personal tax reliefs")

Most countries allow, as a rule, resident taxpayers to deduct from their net income particular types of personal expenses, such as medical expenses, charitable contributions, and sometimes even interest on consumer loans; these deductions are hereafter referred to as "personal expense deductions." In addition, in taxing individuals many tax systems take into account the civil status of the taxpayer, whether they have minor children in their care, and other personal aspects, by granting them fixed-amount personal allowances and tax credits, tax rate differentiations, the privilege to file a joint return (couples), etc.; these benefits will be referred to here as "person-related tax reductions." Both types of relief – hereafter jointly also referred to as "personal tax reliefs" – are based on tax policy considerations to take into account the personal ability-to-pay of individual taxpayers.

Nonresident taxpayers are typically not entitled in the source country to either personal expense deductions or person-related tax reductions. Traditionally, the reason for the source country not to grant these reliefs to nonresident taxpayers is that these taxpayers are supposed to enjoy such benefits in their residence country. An extension of these benefits to them by the source country is assumed to give them double benefits and thereby an advantage over the source country's resident taxpayers. This brings up the fundamental issue how source countries should make the comparison between their nonresident and resident taxpayers to determine whether the former category is treated less favorably. In order to compare its tax treatment of nonresident taxpayers with the treatment of its residents, should the source country restrict the comparison to how it treats its own resident taxpayers who are in exactly the same position as the given nonresident taxpayer with regard to domestic income etc., or should the source country consider the nonresident taxpayer's cross-border aspects and take into account:

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[2] Cf. section 10 of the OECD Commentary on Art. 17, where in the 2008 update the fifth and following sentences were added. The added text includes the suggestion for a paragraph to be added to Art. 17 for states that want to give to nonresident artistes and sportsmen the option to be taxed on a net basis.

> a. how the nonresident is taxed in his own residence country in respect of the income derived from the source country, and/or
>
> b. the additional income the nonresident derives from sources in his residence country and third countries for purposes of determining the tax rate to be applied by the source country to the income from the source country?

The first item, which has not received much attention under the single rule in Article 24 OECD that deals with taxation of nonresident taxpayers (the permanent establishment nondiscrimination provision of paragraph 3), has become a well-known issue in EC tax law. To establish under the EC Treaty's freedom of movement rules whether in a cross-border situation an obstacle is created or discrimination occurs[3] (particularly with regard to dividend and interest income) the following questions arise: (i) may the source country in determining whether a nonresident taxpayer is treated less favorably than a resident taxpayer take into account benefits (e.g. a credit for the source country's tax) that the nonresident is entitled to in his residence country in respect of the given item of income, or (ii) is the source country required to treat the nonresident at par with resident taxpayers irrespective of the way the nonresident's residence country treats the income its resident has derived from the source country.

4. Business deductions vs. personal expense deductions and person-related tax reductions

The essential difference between expenses a taxpayer incurs in connection with his gross income ("business expenses") and "personal expense deductions," is that the first group is by definition related to particular items of income whereas the second group of expenses (deductible personal expenditures) typically lack a connection with items of (domestic and foreign) income.

Most countries restrict in their domestic tax law the right to personal deductions to their resident taxpayers, and, as a rule, deny it to nonresident taxpayers. The permanent establishment nondiscrimination provision of Article 24.3 of the OECD Model, which in its first sentence grants to nonresident taxpayers the right to be taxed on their business income earned through a permanent establishment in the source country not less favorably than resident taxpayers, confirms this practice by denying in its second sentence expressly these nonresident taxpayers the right to the personal expense deductions that nonresident taxpayers have:

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[3] The bottom line for the Court appear to be that it cannot be accepted that in a cross-border situation in the end a loss or deduction that would be taken into account in a full-domestic situation, will not be taken into account anywhere (see *Marks and Spencer*, ECJ 13 December 2005, C-446/03).

> …This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

As noted above, if nonresident taxpayers would be given the right to the personal tax reliefs that the source country grants to its own residents, nonresident taxpayers would be entitled to such reliefs twice. Depending on the marginal tax rates at which the taxpayer is taxed in the source and residence countries, the value of the combined effective tax reductions in the two countries resulting from the personal expense deductions and personal allowances, may or may not give cross-border taxpayers an advantage over taxpayers that derive all of their income from a single country and who are therefore entitled to personal deductions only in that country. It is therefore difficult to understand why countries occasionally have extended in their tax treaties an unrestricted and unconditional right to personal tax reliefs to nonresident taxpayers, as was done in the Article 25.3 of the 1970 Netherlands-Belgium tax treaty:

> Individuals who are residents of one of the States shall benefit in the other State from the same personal allowances, reliefs and deductions on account of civil status or family responsibilities which the last-mentioned State grants to its own residents.

5. Nonresident taxpayer deriving (almost) all of his income from source country

If a resident taxpayer derives (almost) his entire income from one foreign country, generally he cannot effectively take (fully) into account in his residence state the personal expense deductions and person-related tax reductions to which he is entitled under his residence country's domestic tax law. To deal with this obstacle to cross-border movement of persons, in 1993 the European Commission issued a Recommendation under which each member state should tax residents of other member states that derive at least 75% of their taxable income from the first member state, on the same footing with resident taxpayers of that state with respect to business, professional and employment income. The Recommendation indicates that in such a case the residence state of such individuals may opt not to grant "deductions or other tax reliefs" to its residents if they benefit from such deductions or reliefs in the other state. No further details are provided (e.g., what if the source state *partially* grants deductions and reliefs?, but that is perhaps in the nature of a Recommendation (as distinguished from a Regulation and a Directive). The 1995 *Schumacker* decision by the ECJ[4] followed this path shown by the European Commission but increased the 75% threshold to "all or virtually all" which is generally understood as amounting to at least 90%.

[4] ECJ, 14 February 1995, C-279/93

Many countries have introduced or upgraded in their domestic tax law rules that allow nonresident taxpayers that derive most of their income from that country as source country, to opt for taxation in the same manner as is applicable to resident taxpayers (but, of course, only on the income for which they are liable to tax in the source country and not on the worldwide income).[5] It is obvious that this approach provides a solution only if the taxpayer derives (almost) all of his income from a single foreign country and not from more than one foreign country.

6. Proportional granting of personal tax reliefs by residence and source countries

What if the amount of the personal expenses is attributed proportionally to the overall income and that both the residence state and the source state take into account as a deduction only the corresponding fraction of the total personal expenses amount? As a matter of fact, various residence countries do this implicitly by computing the amount of double taxation relief their resident taxpayers are entitled to (or, in case of the foreign tax credit, the limit on the amount of the foreign tax credit) in a way that reduces the amount thereof by that fraction of the personal expenses that equals the ratio of their foreign income over their worldwide income. Clearly, such an approach is acceptable only if the given country when it acts as source country allows a deduction for the personal expenses that are proportionally attributable to the income nonresidents derive from that country. Further, cross-border neutral treatment is reached only when, in cases where the residence country applies this restriction to its resident taxpayers, the source country concerned grants the nonresident taxpayer a supplementary proportional relief.

7. The effect of person-related deductions (personal expense deductions and personal allowances) on residence and source country taxation

If both the taxpayer's residence country and source country permit him to effectively apply personal expense deductions and personal allowances, he will have the benefit of dual deductions. In practice, both countries apply smaller or greater restrictions in applying these deductions, as is demonstrated in the following example.

We assume that resident A (married, two children) of State R has a worldwide income of 500 of which he derives 300 from State S, and that both states apply the same tax rate (a flat 20%) and the same personal allowance (100 for a married person with two children). State R will compute as tax on A's worldwide income after personal allowance: 20% of (500 – 100 =) 400 = 80. If State S as source state does not grant A as a nonresident the deduction of the personal allowance, A's State S tax amounts to 20% of 300 = *60*. If State S does grant A the full personal allowance (100), A's tax is 20% of (300 – 100 =) 200 = *40*. If it grants only the fraction of the personal allowance (100) that

[5] Interestingly, in The Netherlands, the nonresident may opt for being taxed as a resident taxpayer on his worldwide income (including domestic income offsetting foreign losses) with double taxation relief (as applies to resident taxpayers) for those items of his worldwide income for which he would not be taxable as a nonresident taxpayer.

corresponds with the ratio of his State S income (300) over his worldwide income (500), the fraction that State S takes into account is (300/500 of 100 =) 60, resulting in taxable income of A in State S of (300 – 60 =) 240 and a tax amount of (@20%) *48*.

If State R grants A double taxation relief for his State S income in the form of an (income) exemption, it computes the tax due by A by applying its tax rate of 20% to A's domestic income of (200 − 100 =) 100 is *20*. If State R applies exemption through a proportional reduction of the tax computed on the basis of the worldwide income (also "WWI") after deduction of the personal allowance (20% of 400 = 80), it can take into account as foreign income the amount computed in either of the three following ways: (a) without any personal allowance (foreign income of 300 − 0 = 300: reduction of R State's 80 tax on WWI by 300/400 thereof is 60; remaining R State tax: 80 – 60 = *20*), or (b) with deduction of the full personal allowance (foreign income of 300 − 100 = 200: reduction of 80 tax on WWI by 200/400 thereof is 40, with remaining tax of 80 – 40 = *40*), or (c) with deduction of the income-proportional fraction of the personal allowance (foreign income of 300 − 60 = 240: reduction of 80 tax on WWI by 240/400 thereof is 48, with remaining R State tax of 80 – 48 = *32*).

In case State R is a credit country, it has similar choices: it may compute the ordinary credit limitation based on foreign income of 300, 200 or 240 with resulting limitations of respectively 60, 40 and 48.

If A would, as a resident of State R, derive his entire WWI of 500 from State R, his tax would be 20% of (500 – 100 =) 400 = 80. Now A derives of his 500 worldwide income 300 from State S, State R may compute the double taxation relief to be granted to A based on varying assumptions as to State S having taken the personal allowance into account (full, partial or no personal allowance). Many countries that provide double taxation relief in the form of an ordinary foreign tax credit or in the form of an exemption through a proportional reduction of the tax due on the worldwide income compute the relevant amount of foreign income by assuming that the foreign country has allowed as a deduction in computing the taxable amount of foreign income a proportional fraction of the personal allowance: 300 − 60 = 240 (in that case R State's 80 tax on WWI will be reduced by 240/400 = 48 to 32). At the same time, in the absence of a situation where the taxpayer derives at least 90% of his worldwide income from the foreign country (in which case a number of source countries will grant nonresident taxpayer A a full personal allowance) the source country will typically not permit A to deduct the whole or a even a proportion of the personal allowance. As a result, the combined tax amounts due by A to States R and S (both states applying the same 20% tax rate) will amount to 60 (State S tax) plus 32 (State R tax) is 92, compared to 80 if A would have derived his 500 WWI income from State R only.

If resident A of State R derives his income partially from State S, in current country practice the disallowance by State S of personal allowances to nonresident taxpayers combined with restricted double taxation relief granted by State R results in a higher tax burden for A compared with the situation where A derives the same amount of

overall income from a single country. At the same time – and this involves a different perspective – when a residence country grants double taxation relief in the form of an exemption through a proportional reduction of the tax on WWI or in the form of an ordinary foreign tax credit, assuming that State S applies (different from the example above) a graduated (i.e., progressive) income tax rate, the taxpayer may benefit from the fact that the exempt income respectively the ordinary credit limitation is computed by State R as if the State S had determined (but generally would not have done so) its tax rate to be applied to the income A derived from State S on the basis of the average rate that State S would have applied to A's WWI.

All in all, many states in the position of State R may at the same time overtax resident taxpayer A who derives part of his income from State S, by effectively reducing the personal allowance he is entitled to take into account in determining his tax liability in State R, and undertax him by basing the double taxation relief granted to him on an unrealistically high amount of tax relating to the foreign income. Depending on the circumstances the resulting tax burden imposed by State R will amount to either overtaxation or undertaxation, and only accidentally a tax burden may result that equals to the burden in a full domestic situation.

8. Conclusion and proposal

As is clear from the preceding paragraphs, even under "laboratory" conditions of residence and source countries having identical tax rules, it is difficult if not impossible with individual income tax systems that apply person-related tax reliefs and graduated tax rates, to design rules that do not result for a taxpayer with cross-border income in an overall tax situation which differs from the situation in which he had derived all of his income from a single country, unless both residence and source states accept a proportional approach to applying personal deductions and tax rates.

In 1999, I contributed to the Festschrift of my Leiden colleague Ferdinand Grapperhaus a brief essay (in Dutch) on what I dubbed "fractional taxation" ("FT") of taxpayers with cross-border income.[6] In that contribution I developed an approach to cross-border taxation where countries in taxing cross-border income give up their traditional roles as residence countries and source countries. Instead, each country individually computes the cross-border taxpayer's worldwide income and the amount of tax that would be due on that income, but subjects the taxpayer only to that fraction of such tax that reflects the ratio of the taxpayer's domestic income over worldwide income (both computed under the pertinent country's own tax rules). In this way, every element of the given country's tax rules (including personal expense deductions and person-

[6] *C. van Raad,* Fractionele belastingheffing van EU buitenlandse belastingplichtigen, in: Liberale Gifte (Vriendenbundel Ferdinand Grapperhaus) (Kluwer, Deventer, 1999), pp. 297-305. A slightly expanded English language version appeared in the Festschrift for Sven-Olov Lodin: *Kees van Raad*, Fractional Taxation of Multi-State Income of EU Resident Individuals (in: Liber Amicorum Sven-Olof Lodin, Kluwer 2001), pp. 211-221.

related tax reductions) is applied to the taxpayer concerned *pro rata parte* (proportionally). Given the larger and smaller differences among countries" individual income tax systems, this approach may be the closest one can get to cross-border neutrality of income taxation.

The FT approach described in the preceding paragraph can be summarized in the following three steps to be taken by each of the countries from which the taxpayer derives income:

1. compute the taxpayer's worldwide income on basis of its own tax rules;
2. apply its own tax rate top that worldwide income;
3. apply to the resulting tax the fraction: domestic income over worldwide income (both computed under the given country's domestic tax rules).

The following numerical example illustrates the operation of the FT system:

EXAMPLE

Resident X of France derives income not only from his residence country F (France) but also from NL (Netherlands) and G (Germany). The amounts of Income derived from these countries are, under the rules of each of these countries, determined as follows:

France	1. Under French tax law: income from France itself	45
	Netherlands	30
	Germany	15
	2. Worldwide income according to French tax law	*90*
	3. Personal deductions *<assume>*	30
	4. Taxable income	60
	5. French tax *<assume>*	*16*

#	1. net income derived from F	NL	G	2. Total income [= 1]	3. Personal deductions permitted <assume>	4. Tax. income [= 2 -/- 3]	5. Tax <assume>	6. Fraction [= 1 / 2 *]	7. Tax [= 6x5]
F	45	30	15	90	30	60	16	45/90	8
NL	55	20	5	80	12	68	24	20/80	6
G	48	12	15	75	15	60	20	15/75	4
									18

\# Computation of the per-country amounts under the law of F, NL and G

Of course, as it would be prohibitively impractical to require taxpayers with foreign income to file a complete tax return in each country from which they derive income, taxpayers should be given the option to be taxed on their gross income at a flat rate of, e.g., 35%. But if they prefer to be taxed right, they should be allowed to do their homework.

The FT approach reminds one of Home State Taxation ("HST") which was developed as a step to harmonized company taxation within the EU.[7] An important difference (and drawback of the fractional taxation system) is that in the HST-system one state computes the WWI that, after distribution of the amount thereof among the states involved, is used in all countries involved by subjecting the income slice received to the (corporate) income tax rate of the given country.

[7] Malcolm Gammie and Sven-Olof Lodin, The Taxation of the European Company, ET 1999/8, pp. 286-294.