Telecommunications & Methods for Avoiding Double Taxation

By Paul DePasquale and Alyssa Varley, Baker & McKenzie Zurich

[Abstract]

Cross-border business and investment activity invariably involves the tax rules of more than one jurisdiction. When multiple jurisdictions impose separate and sometimes conflicting tax rules, cross-border activities can be subject to double taxation. The principal mechanisms for avoiding double taxation are (i) to exempt the income from taxation in one or more jurisdictions (the "exemption method") or (ii) to allow double taxation but permit the taxpayer to claim a credit or deduction for taxes paid in one jurisdiction against his or her tax liability in another jurisdiction (the "credit method"). .

This paper provides a brief overview of the mechanisms governments use for avoiding double taxation. After a brief discussion of the current treatment of the joint provision of international wireless telecommunications services under the International Telecommunications Regulations (“ITRs”), we discuss the principal mechanisms for avoiding double taxation and principal variations for each method. Finally, we illustrate the U.S. experience in mitigating state-level double taxation on telecommunications services.

[Text of Article]

Technological developments have increased cross-border business and investment activity. This is particularly true in the case of telecommunications activities, which both enable and benefit from activity in multiple jurisdictions. Cross-border activities invariably implicate the tax rules of more than one jurisdiction. International tax methods for alleviating double taxation developed in the context of a global economy based on the manufacture and trade of tangible goods where location of production facilities, employees, and sales were easily traceable. As such, these factors became important in determining taxation. More often than not, these rules are poorly suited to internet and wireless technologies where services and information are provided remotely and in intangible forms.

When multiple jurisdictions impose separate and sometimes conflicting tax rules, cross-border activities can be subject to double taxation (taxation by two or more countries of the same income, asset or transaction). Double taxation can impede cross-border economic activity and capital flows. Governments generally mitigate the risks of double taxation through unilateral relief in the form of domestic legislation or through bilateral relief by entering into double taxation agreements (“DTAs”). Whether relief is unilateral or bilateral, the principal mechanisms for avoiding double taxation are (i) to exempt the income from taxation in one or more jurisdictions (the "exemption method") or (ii) to allow double taxation but permit the taxpayer to claim a credit or deduction for taxes paid in one jurisdiction against his or her tax liability in another jurisdiction (the "credit method").

This paper provides a brief overview of the mechanisms governments use for avoiding double taxation. After a brief discussion of the current treatment of the joint provision of international wireless telecommunications services under the International Telecommunications Regulations (“ITRs”), we discuss the principal mechanisms for avoiding double taxation and the principal

variations for each method. Finally, we illustrate the U.S. experience in mitigating state-level double taxation on telecommunications services.

The Melbourne Agreement

The International Telecommunications Union ("ITU") is the leading United Nations agency for information and communication technology issues. The ITU provides a global platform for both governments and the private sector for promoting information and communication technology issues and standardization. In 1998, the ITU adopted the ITRs (commonly referred to as the "Melbourne Agreement"). The ITRs provide a regulatory framework for the provision of international telecommunications services.[1]

One of the principal purposes of the ITRs is to promote efficient operation and harmonious development of telecommunications across jurisdictions. Double taxation generally reduces tax efficiency and "capital export neutrality." Broadly speaking, capital export neutrality is the principle that taxpayers should be subject to tax rates on domestic investment that are equal to the tax rates on foreign investment. Double taxation can impede the goals of promoting efficient operation and harmonious development of telecommunications and impede capital export neutrality.

Article 6.1.3 of the ITRs provides that:

> Where, in accordance with the national law of a country, a fiscal tax is levied on collection charges for international telecommunication services, this tax shall normally be collected only in respect of international services billed to customers in that country, unless other arrangements are made to meet special circumstances.[2]

ITRs Article 1.6 of Appendix 1 provides, "[w]here an administration has a duty or fiscal tax levied on its accounting rate shares or other remuneration, it shall not in turn impose any such duty or fiscal tax on other administrations."[3] The ITRs do not define the term "fiscal tax."[4] The ITRs, however, do qualify the reference to "fiscal tax" with "in accordance with the national law of a country."[5] This qualification is understood to provide that the term "fiscal tax" be defined in accordance with the domestic laws of member states.[6]

The meaning and application of Article 6.1.3 is not entirely clear. DTAs, for example, generally define in precise detail the taxes covered. The lack of a precise definition of "fiscal tax" for purposes of the ITRs results in a lack of clarity and creates uncertainty.[7]

The ITU is considering proposals to revise Article 6.1.3. Two of the proposals are as follows:

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[1] International Telecommunications Union, Final Acts of the World Administrative Telegraph and Telephone Conference [WATCC-88], International Telecommunication Regulations (Geneva 1989) [hereinafter ITRs].
[2] *Id.,* at Art. 6.1.3.
[3] *Id.,* at Appendix 1, Art. 1.6.
[4] Marc D. Ganz, 946 T.M., *U.S. International Taxation of Telecoms*, BNA Portfolio.
[5] ITRs, *supra* note 1, at Art. 6.1.3.
[6] *Id.*; *see also* ITU CONF/PP-9420 (July 8, 1994).
[7] Ganz, 946 T.M., *U.S. International Taxation of Telecoms*, BNA Portfolio.

Alternative 1:

> Countries are free to levy fiscal taxes on international telecommunication services in accordance with their national laws, but international double taxation must be avoided.

Alternative 2:

> Countries shall not apply taxes to incoming international calls, to avoid double taxation.

In order to mitigate the potential consequences of double taxation and to insure that tax rules are applied consistently and fairly, a mechanism for avoiding double taxation should (i) protect against the risk of double taxation in instances where the same income is taxable in two countries; (ii) define which taxes are covered by the agreement; (iii) provide a procedural framework for enforcement and dispute resolution; (iv) protect each government's taxing rights; and (v) protect against attempts to avoid or evade tax liability.

Two Basic Types of Double Taxation

Developing effective methods for avoiding double taxation requires an understanding of the circumstances under which double taxation arises and the principal mechanisms governments use to avoid double taxation.

There are two basic types of double taxation and two basic conceptual mechanisms for avoiding double taxation.

The first type of double taxation is often called "economic double taxation." Economic double taxation occurs where two different persons are subject to tax on the same income or capital.[8] Economic double taxation is permitted to occur in many instances in domestic and international tax systems. For example, economic double taxation is allowed to take place when a corporation is taxed on corporate income and the same profits are taxed a second time to the shareholder of the corporation when the corporation distributes the profits as a dividend.[9]

The second type of double taxation is "juridical double taxation." Juridical double taxation occurs where one person is subject to tax on the same income or capital by more than one tax authority.[10] This paper focuses on mechanisms for avoiding juridical double taxation rather than economic double taxation.

There are three situations when juridical double taxation occurs. Juridical double taxation can occur where two countries claim that the same income of a person is sourced to their state, or where one or both jurisdictions taxes their citizens or residents on world-wide income regardless

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[8] Klaus Vogel, *Double Taxation Conventions*, 3rd edition, Kluwer Law International, p. 1124.

[9] Some jurisdictions address economic double taxation, in whole or in part, by adopting an integrated corporate and shareholder tax. This can be accomplished by giving the corporate shareholder a credit for all or a portion of the corporate taxes paid on the distributed profits. Countries that have adopted complete or partial integration include France, Germany and the United Kingdom. The United States has considered integration proposals in the past but to date has not adopted integration for most corporations and shareholders.

[10] *Id.*, at p. 1124.

of source.[11] DTAs typically mitigate such "source-source" conflicts by providing for uniform source rules and allocating primary or exclusive taxing jurisdiction to one of the contracting states based on those rules.[12] Second, double taxation can occur when two or more states regard the same person as resident in their jurisdiction.[13] DTAs typically alleviate such "residence-residence" conflicts by providing for detailed definitions of residency including tiebreaker provisions for special cases such as where an individual is a part-year resident in both of the contracting states. Third, double taxation can occur when the same item of income is taxed by both the jurisdiction where the income originates and by the jurisdiction in which the recipient of the income is resident.[14] DTAs typically mitigate such "source-residence" conflicts by allocating primary or exclusive taxing rights to one of the contracting state, typically by prioritizing one state's claim over the other state's claim.

Two Basic Conceptual Mechanisms for Avoiding Double Taxation

Both unilateral relief in the form of domestic law and bilateral relief in the form of DTAs utilize one of two basic methods for avoiding double taxation: (i) the exemption method, or (ii) the credit method. There are variations of each method as discussed further below.

Exemption Method

Under the exemption method, the residence jurisdiction does not tax income that the source jurisdiction may tax.[15] There are two variations of the exemption method: full exemption and progressive exemption.

Full Exemption

Under the full exemption method, the income from the source jurisdiction is not subject to tax in the residence jurisdiction and such income from the source jurisdiction is ignored for purposes of computing the residence jurisdiction tax. For a tax system with a progressive rate structure and a full exemption, a taxpayer may be better off from a tax perspective by earning income outside of its residence jurisdiction than it would be by earning income solely in its residence jurisdiction. This is a violation of the capital export neutrality principle.

For purposes of the examples in this paper, assume that the rate of tax on $75 of income under residence country ("R") law is 35% and the rate of tax on $100 of income is 40%. If Company, a corporation resident in R, has $100 of income derived solely from R, Company will pay $40 in tax to R.

Example 1:

> Suppose Company has $100 of income, $30 of which is from source country ("S"). S imposes tax on income sourced to S at a 25% rate. Without relief from double taxation, Company would pay $47.5 in total tax, consisting of $40 to R

[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*

and $7.5 to S. The tax result for Company is worse than if Company had earned $100 solely from sources in R.[16]

Under a full exemption, Company would pay $24.5 of tax to R (35% tax on its $70 of R source income) and would pay $7.5 of tax to S (25% tax on its $30 of S source income) for a total tax liability of $32. In this case, Company is better off from a tax perspective than it would have been had Company earned income solely from R. Under the full exemption method, this would generally be the case unless the S income tax rate is higher than the R income tax rate.

Progressive Exemption

Under the progressive exemption method, the residence jurisdiction would not tax income arising in the source jurisdiction but would count that income for purposes of determining the residence country tax rate that should apply to the taxpayer.

Example 2:

Using the assumptions from Example 1, with a progressive exemption, Company would pay $28 of tax to R (tax on its $70 of R source income at the higher 40% tax rate) and would pay $7.5 of tax to S (25% tax on its $30 of S source income) for a total tax liability of $35.5.

In Example 1 and Example 2, the tax relief Company receives from R ($15.5 in Example 1 and $12 in Example 2) is greater than the actual tax that Company pays to S ($7.5 in both Example 1 and Example 2) because the income earned in S is taxed only at the lower S tax rate.

Credit Method

Under the credit method, the residence state taxes total worldwide income of a taxpayer resident in that state but will allow a credit against the residence country tax liability for taxes paid to the source state. Like the exemption method, there are two basic types of credit mechanisms: the full credit and the ordinary credit.

Full Credit

Under the full credit method, the residence country will allow a credit of the full amount of source country taxes against the residence country tax liability.

Example 3:

Using the assumptions from Example 1, Company would tentatively owe tax of $40 in R (40% tax on the total income of $100), but could offset that liability by taking a credit for the $7.5 of tax (25% tax on its $30 of S source income) paid to S. Company would then only pay $32.5 of tax to R. Company's total tax liability would be $40 (the same as if Company's income came solely from R).

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[16] The examples in this paper are based on examples in Vogel, *Double Taxation Conventions*, 3rd edition, Chapter V.

> If, however, S imposes a tax of 45% on Company's income from S, then Company would be able to offset its R tax liability by the $13.5 of tax (45% tax on its $30 of S source income) paid to S. Accordingly, Company's total tax liability would be $40 (as if taxed under the 40% tax rate of R) but this tax liability would consist of $26.5 of tax payable to R and $13.5 of tax payable to S.

Ordinary Credit

As shown in Example 3, the credit mechanism achieves tax neutrality for the taxpayer but a full credit mechanism can result in R country losing revenue to S country. Due to this situation, most countries do not allow a full credit for taxes paid to a source country against residence country tax liabilities. The more common credit mechanism is the so-called "ordinary credit," whereby the source country tax liability is allowed to offset the residence country tax liability only to the extent that the income would have been taxed in the residence country.

Example 4:

> Under an ordinary credit mechanism and applying the assumptions of Example 3, R would allow a credit for taxes paid to S only to the extent of the tax that R imposed on the S source income (absent the credit).
>
> Accordingly, Company would be able to offset its $40 tax liability (40% of $100) to R by $12 (40% of $30) of the tax paid to S. Company's total tax liability would be $41.5 with $13.5 paid to S (45% of tax on $30) plus $28 paid to R ($40 tax liability minus the credit for $12 tax paid to S). Applicable laws, however, may allow taxpayer to carry forward the unused credit of $1.5 to future years.[17]

Under the credit method, the state of residence never needs to provide more tax relief than the tax actually paid to the source state, which, as illustrated above, can happen under the exemption method.[18] If the tax rate in the source state is lower than the tax rate in the residence state, the taxpayer will always have to pay the same amount of tax as he would have had to pay if he were taxed only in the residence state.[19] Under an ordinary credit mechanism, if the tax rate in the source state is higher than the tax rate in the residence state, the tax result would be less favorable to the taxpayer than if the taxpayer were taxed solely in the residence state because the taxpayer is effectively required to pay the higher of the R tax rate and S tax rate on the S source income.[20]

<u>Avoiding Double State Taxation in the United States Context</u>

The United States system of constitutional federalism featuring dual sovereignty of the Federal and state governments creates the potential for double taxation at the state level similar to double taxation that can occur in the international context. The Commerce Clause of the U.S.

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[17] Use of the credit in later years may be subject to additional restrictions and limitations. Because the nature of these restrictions and limitations varies from country to country, discussion of these additional restrictions and limitations is beyond the scope of this article.

[18] Vogel, at p. 1128

[19] *Id.*

[20] *Id.*

Constitution gives the U.S. Congress the power to regulate interstate commerce.[21] This clause has been interpreted as containing a converse element, the so-called "dormant commerce clause," by which state governments are prohibited from passing legislation that improperly burdens or discriminates against interstate commerce.[22]

In the context of state taxes, the U.S. Supreme Court set forth a four-part test to determine the constitutionality of a tax under the commerce clause. Under that test, (i) the out-of-state taxpayer must have a substantial connection (nexus) with the state, (ii) the tax must not discriminate against interstate commerce, (iii) the tax must be fairly apportioned, and (iv) there must be a fair relationship between the tax and the services provided.[23] To meet the fair apportionment requirement, states generally tax income attributable to that state by applying some form of formulary apportionment or credit.

The Goldberg Case

In 1985, the state of Illinois enacted a 5% tax on the gross charge of interstate telecommunications originating or terminating in Illinois regardless of where the telephone call is billed or paid.[24] The Illinois statute provided a credit upon proof that the taxpayer paid a tax in another state on the same telephone call that triggered the Illinois tax. In *Goldberg v. Sweet*,[25] the constitutionality of the Illinois excise tax was challenged in the U.S. Supreme Court under the dormant commerce clause. The Supreme Court held that the Illinois excise tax did not violate the dormant commerce clause because it satisfied the test outlined above.[26]

In *Goldberg*, the Supreme Court held that both the state in which a transmission originates and the state in which the transmission terminates may tax the telecommunications service, if each state could establish nexus with the taxpayer.[27] The Court found that a state would satisfy the constitutional nexus requirements if the service address (i.e., the location of the equipment to which the transmission is charged) or the taxpayer's billing address is located within the state.[28]

The Mobile Telecommunications Sourcing Act

Applying the *Goldberg* reasoning to wireless telecommunications can lead to double taxation and confusion regarding the need to pinpoint the physical location of origination.[29]

In 2000, the U.S. Congress enacted the Mobile Telecommunications Sourcing Act of 2000 (the "Act") to simplify billing statements, reduce the potential for double taxation, and reduce and

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[21] U.S. Constitution, Article I, Section 8, Clause 3.
[22] *See, e.g., City of Philadelphia v. New Jersey,* 437 U.S. 617 (1978); *Dean Milk Co. v. City of Madison, Wisconsin*, 340 U.S. 349 (1951); *Hunt v. Washington State Apple Advertising Comm.*, 432 U.S. 333 (1977).
[23] *Complete Auto Transit v. Brady*, 430 U.S. 274, 288-289 (1977).
[24] *Goldberg v. Sweet*, 488 U.S. 252 (1989).
[25] *Id.*
[26] *Id.* At the lower court level, the taxpayer had alleged that the tax also violated the Due Process Clause and Equal Protection Clause of the United States Constitution. These clauses also limit state taxing authority. The taxpayer abandoned these claims on appeal to the Supreme Court.
[27] *Id.*
[28] *Id.*
[29] James A. Amdur, 1810-2nd T.M., *State Taxation of Transportation, Telecommunications, and Energy Companies*, BNA Portfolio.

simplify the tax rules for both carriers and state and local governments.[30] The Act limits a state's right to tax telecommunications to the place of "primary use."[31] The "place of primary use" is the residential or primary business address of the customer. Under the Act, only the place of primary use has jurisdiction to tax wireless telephone calls, irrespective of the location of the customer or the jurisdictions in which the call originates, terminates, or is routed through. [32] Accordingly, one of the goals of the Act is to avoid double taxation by providing a uniform source rule, conceptually similar to the process by which independent nation-states seek to set out uniform source rules in DTAs.

Conclusion

This paper illustrates the basic mechanisms governments use to avoid double taxation. The basic methods are the exemption method and the credit method. Cross-border activities and non-conformity among tax laws create discontinuities that, in turn, create the potential for double taxation. Governments may mitigate, although not in every case eliminate, these risks through entering DTAs, which provide greater convergence of tax laws, particularly with regard to sourcing rules.

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[30] 114 Stat. 626, Public Law 106-252; 4 U.S.C. §§ 116-126; see Kevin P. Thompson, *Prospects Grow Dim: 106th Congress Will Resolve The Thorniest Issues in Internet Taxation Debate*, in State and Local Taxation; What Every Lawyer Needs to Know, at 133, 144 (PLI Tax Law & Practice, Order No. J0-003J, 2001).

[31] 4 U.S.C. § 122.

[32] *Id*.