EDITORIAL

Income Tax and Income Shift by Individuals

1 Introduction

There are increasing concerns with double non-taxation or insufficient taxation of remote work, mobile individuals and their wealth. This is not a new topic from the angle of hidden wealth, and the problem has been primarily dealt with by the international standard on exchange of information, i.e., from the perspective of harmful tax competition and tax evasion.[1] Recently, the inadequacy of the international tax system for taxing individuals with cross-border income is raising different proposals to restore the allocation of taxing rights and attempt to effectively address planning and avoidance.[2]

In this editorial, I want to discuss some critical issues related to residence, source, and alternative connecting elements that are considered for taxing income of mobile individuals. I take the opportunity to also refer to some of the chapters in the forthcoming book *Taxing People: The Next One Hundred Years, ed. by Tsilly Dagan and Ruth Mason, Cambridge University Press.*

2 Income shift by resident individuals

Overall, there is some parallel in this discussion on how to tax individuals with the base erosion and profit-shifting (BEPS) project that concerns multinationals (MNEs).[3] One is that the wealthier entities, like MNEs, are not paying their fair share because they can choose where to be taxed. Moreover, jurisdictions compete to attract wealthy taxpayers by reducing taxes in the same manner that those same jurisdictions reduce them to attract MNEs. Moreover, there is also awareness that residence, as a condition to tax worldwide income, and as legally defined, is no longer sufficient for taxing individuals in a globalized economy even if we face deglobalization trends. Ultimately, residence should be replaced or complemented by other more meaningful connecting elements that would reflect some type of allegiance with the taxing jurisdiction. A discussion on the proper connecting elements to tax MNEs has also been occurring for some years now as market states are claiming that they do not receive their fair share in the current digitalized economy.[4]

3 Do we still want full tax liability? The European Union case

Thus, there is concern on rising inequalities due to stateless taxpayers and the fact that states are not receiving enough revenue for redistribution under residence taxation. There is certainly a preliminary question related to fair taxation of individuals with global income.

That is the question of whether we still want to distinguish between full and limited liability under income tax, at least in the case of mobile individuals.[5] We could, for example, keep residence as a connecting element and apply progressive rates combined with the exemption of foreign income (exemption with progression). Full liability would be relevant for calculating progressive rates and that would still allow the residence state to maintain some redistributive role.[6] But then, for symmetry reasons and to

Notes

1 Ana Paula Dourado, *Article 26*, in *Klaus Vogel on Double Taxation Conventions*, vol. II (5th ed., Ekkehart Reimer & Alexander Rust eds, Wolters Kluwe, 2002), mno 2–4, 21, 26.

2 *See* the several contributions in: *Taxing People: The Next One Hundred Years* (Tsilly Dagan & Ruth Mason eds, Cambridge University Press), forthcoming.

3 OECD, *Base Erosion and Profit Shifting*, https://www.oecd.org/en/topics/base-erosion-and-profit-shifting-beps.html (accessed 1 Dec. 2024). *See* the reference to a BEPS project addressed to individuals in: Wolfgang Schön, *Must Everybody Pay Tax Somewhere?*, in Taxing People, *supra* n. 2, Ch. 1.

4 A. P. Dourado, *Digital Taxation Opens the Pandora Box: The OECD Interim Report and the European Commission Proposals,* 46 Intertax 565–572 (2018), doi: 10.54648/TAXI2018058 (accessed 1 Dec. 2024); Wolfgang Schön, *One Answer to Why and How to Tax the Digitalized Economy*, 47 Intertax 1003–1022 (2019), doi: 10.54648/TAXI2019105, https://kluwerlawonline.com/journalarticle/Intertax/47.12/TAXI2019105 (accessed 1 Dec. 2024).

5 In Ch. 2 (*Comfortably Numb: Should the Reign of Residence Over the International Tax Regime Continue in the 21st Century?*) of: Taxing People, *supra* n. 2, Yariv Brauner recommends abandoning residence taxation in favour of exclusive source taxation and contends for a formulary approach to determining source.

6 This solution was adopted by the Netherlands in its tax treaties with France, Germany, and the United Kingdom at the time of the facts of the *De Groot* case: CJEU, 12 Dec. 2002, Case C-385/00, *de Groot*, EU:C:2002:750.

INTERTAX, Volume 53, Issue 2

avoid loss of revenue, personal and family circumstances would not be fully taken into account by the residence state. Thus, the taxpayer would be in a weaker position, and the role of the residence state would be less relevant in terms of personal taxation. To overcome this disadvantage, the source states could allow a deduction of personal and family-related expenses in proportion to the income received in those jurisdictions and, if this would be the case, progression should also be applied by the source states.

For EU tax lawyers, the latter solution would not be a novelty as it has been required by the Court of Justice of the European Union (CJEU) under certain circumstances.[7] However, the same court did not permit the residence state to restrict the deduction of expenses related to personal and family circumstances in proportion to the income obtained in that state.[8] By deciding in that way, it reinforced the rights to personal taxation in the European Union,[9] but it did so without paying attention to the revenue aspect because it forced residence states to incur expenses while suffering a loss of revenue. This outcome is inherently a problem as it reduces financial resources for supplying public goods and services and for redistribution. In any event, currently in the EU, there is some ambiguity in the role that the residence and source states take regarding full tax liability, progressive taxation, and personal and family circumstances related expenses.

4 How to ensure full tax liability: citizenship or residence? the problem of non-dom regimes

Let us assume without discussing it that full tax liability still makes sense and that it is still applicable in a certain state. But which state? Full tax liability has generally been related to taxation of residents and global income. Article 4 of the OECD Model Convention contains the criteria to define a resident of a contracting state under a tax treaty that follows the model: domicile, residence, place of management, or any other criterion of a similar nature. There is broad consensus that the enumerated criteria would each constitute a basis for full tax liability on world-wide income.[10] They aim at covering, as far as individuals are concerned, 'the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax)'.[11]

The second sentence of Article 4 §1 currently excludes from the concept of residence 'any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'. Even so, the option for territorial taxation in the residence state does not preclude application of a bilateral tax treaty concluded on the basis of the OECD Model Convention as long as it is the standard criterion.[12]

However, territorial regimes applied to a specific category of residents (non-habitual or non-domiciled residents, i.e., *non-dom regimes*) providing tax exemptions or other more favourable regimes (such as special rates on gross income and exempting passive income accrued abroad) do not seem to be covered by tax treaties as results from the cited second sentence of Article 4 §1. *Non-dom regimes* are not the standard or the reference regimes applicable to residents, and non-habitual residents do not necessarily reveal a relationship of proximity (personal attachment) with the non-habitual residence state. They also foster tax exiles, a shift in residence for which the principal purpose is or may be to obtain the advantageous *non-dom* regime.

Moreover, these regimes targeted at individuals have close similarities with those examined by the European Commission and the EU Member States under the Code of Conduct and its criteria on harmful tax competition.[13] There are also similarities between the *non-dom regimes* and the state aid regimes prohibited in the European Union and concerning corporations because, as mentioned before, the former are not the reference regime for taxing income from resident individuals.

*Non-dom regime*s are a way to circumvent full taxation by a residence state, but the shift of residence to any state for tax reasons – i.e., due to lower taxation – poses the question of whether residence is still the proper connecting element for determining personal taxation. Tax competition to attract highly mobile individuals connected with revenue loss and wealthy individuals not paying their fair share could justify replacing residence by citizenship. States would then tax the global income of their

Notes

7 CJEU, 14 Feb. 1995, Case C-279/93, *Schumacker*, EU:C:1995:31.

8 CJEU, *de Groot*, *supra* n. 6.

9 On a symmetric case to *de Groot* requiring the source state to allow deductions of personal benefits: CJEU, 9 Feb. 2017, Case C-283/15, *X.*, EU:C:2017:102: 'Article 49 TFEU must be interpreted as precluding a Member State, the tax legislation of which permits the deduction of "negative income" relating to a dwelling, from refusing the benefit of that deduction to a self-employed non-resident where that person receives, within that Member State, 60% of his total income and does not receive, within the Member State where his dwelling is located, income that enables him to qualify for an equivalent right to deduct': para. 43.

10 Klaus Vogel on Double Taxation Conventions, Kluwer 154–159 (1991); Supreme Court of Canada, *Crown Forest Industries Ltd v. Canada*, 2 SCR 802 [1995].

11 Paragraph 8 of the Commentary on Art. 4 of the 2017 OECD Model Tax Convention.

12 This option for territorial taxation is illustrated by the Netherlands regime under the aforementioned *De Groot* case (judged by CJEU), *supra* n. 6.

13 A. P. Dourado, *Aggressive Tax Planning and Harmful Tax Competition, in Research Handbook on European Union Taxation Law*, Ch. 18, 390–409 (Christiana HJI Panayi & Werner Haslehner eds, Edoardo Traversa, Elgar 2020).

citizens independently of them being residents or non-residents and, in this manner, a shift of residence for tax reasons, i.e., a tax exile, would be prevented.[14]

However, this option would require international coordination as individuals could otherwise shift their citizenship to states that do not tax non-resident citizens. In the absence of international coordination and if a state would not tax them, residence states should intervene and do so.[15] A combination of citizenship as the main criterion plus residence as a complementary one would revert the order of the current Article 4 of the OECD Model Convention, and it is doubtful that there are many advantages in that reversal.

First, the main problem with selecting citizenship as the principal connecting element for personal taxation lies in its justification. The old *US Cook v. Tait* decision (1924) basing taxation of non-resident citizens on the benefits principle seems correct by addressing it as a principle to be tested: does the government benefit the citizen and her or his property wherever found, and does it have the power to make the benefit complete? It must be questioned whether there is relevant personal protection, property protection, a right to vote, a right to enter the state, and past benefits legitimizing citizenship taxation. If the answer is negative, and it will be in most countries around the world, it does not seem legitimate to tax non-resident citizens because there is not enough political allegiance (including the right to vote) and insufficient economic allegiance.

Citizenship taxation would also be extremely complex to implement,[16] and there is another practical problem. Resident states are the primary beneficiaries of exchange of information on tax matters as they receive information from the source states to implement full liability – worldwide income taxation. Because residence is ascertained by criteria that reveal permanence, it is expected that a significant part of the taxpayer's assets will be located in the residence state. If so, those assets could be seized to pay the tax due on worldwide income as revealed by exchange of information and if enforced payment is necessary.

In contrast, non-resident citizens may often possess no assets in the state of citizenship since their permanent home or centre of vital interests is elsewhere. It would therefore be of no benefit to provide information to the state of citizenship in the absence of assets therein unless states would engage in assisting in collection on behalf of the citizenship state which is not realistic. In fact, this issue as foreseen in the current OECD Model Convention is optional due to existing national legal constraints in many countries to engage in it.[17]

In the European Union, there is a (binding) directive for assistance in collection on the basis of source and residence,[18] but replacement of residence by citizenship as a connecting element for full taxation could be held as a restriction to the free movement of workers and establishment. It would therefore be incompatible with the Treaty on the Function of the European Union.

Thus, residence is still the element that reveals stronger allegiance for the purposes of full taxation and its implementation, at least while and if digital nomads are not a significant number of taxpayers. Stated otherwise, the hierarchy in Article 4 OECD Model Convention for determining the meaning of residence and consequent entitlement to full liability in the residence state is still correct: permanent home, centre of vital interests, and nationality. The fact that non-citizen residents are not generally entitled to vote and are therefore not members of the political community in which they reside is compensated by their constructed social, cultural, and family links in that community of residence.

5 Concluding remarks: a reinforced residence and switch-over rules

We go back to where we began whereby countries still face the challenge of reduced tax revenue due to mobile individuals and tax competition to attract them. We will probably need some minimum coordination on personal income tax as is the case for taxation of MNEs as well as other taxes levied on wealth.[19] Right now, it is important to strengthen implementation of the residence as a connecting element if full taxation and redistribution are to be kept and combine it with switch-over rules.

An effective implementation of residence recommends continuously improving exchange of information and adopting rules that prevent double non-taxation. Unilateral or coordinated exit taxes as well as trailing taxes on the transfer of residence could deter or reduce the number of tax exiles, especially if there is an abusive (non-genuine) shift of residence. Exit taxes are levies imposed by a country on individuals or businesses when they decide to leave the jurisdiction permanently

Notes

[14] This is the recommendation by Reuven Avi-Yonah, *Taxing Nomads: Reviving Citizenship-based Taxation for the 21st Century*, in Taxing People, *supra* n. 2, Ch. 3.

[15] This is also proposed by Reuven Avi-Yonah, *Taxing Nomads, supra* n. 14.

[16] In favour of a combination between citizenship and residence: Tsilly Dagan & Ruth Mason, *Reconsidering Citizenship Taxation* in Taxing People, *supra* n. 2, Ch. 4.

[17] *Model Tax Convention on Income and on Capital*, Full version as it read on 20 Nov. 2017, (Footnote to Art. 27 OECD Model Conventions: M-75).

[18] COUNCIL DIRECTIVE 2010/24/EU of 16 Mar. 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures, JOL 84 (31 Mar. 2010), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32010L0024 (accessed 1 Dec. 2024).

[19] *See* other chapters in Taxing People, discussing how to tax individuals such as: Daisy Ogembo, *Transformative Constitutionalism: The Role of Citizens in (Tax) State Building – the Case of Kenya,* in Taxing People, *supra* n. 2, Ch. 8; Diane Ring, *A Century of Labor and Taxation,* in Taxing People, *supra* n. 2, Ch. 9.

or transfer their tax residency to another country.[20] Trailing taxes are levied on previous nationals or residents, for a subsequent period limited in time (e.g. ten years).[21] Because trailing taxes rely on legal fictions and therefore artificially create a citizenship or residence connection, their compatibility with tax treaties could be questioned.

In the European Union, exit taxes and trailing taxes have had different readings by the CJEU. While exit taxes on individuals have been declared restrictive to the exercise of the fundamental freedoms,[22] a trailing tax concerning exit to a non-EU country has been allowed.[23] It was not clear in the CJEU judgment why the latter was compatible with the European Community Treaty, however I am not going to comment on the CJEU decisions on exit taxes and trailing taxes in this editorial.

The point I would like to briefly raise is that exit taxes could be allowed in the EU in the case of abuse, that is, if the transfer of residence to another Member State or a third country is not genuine. In turn, trailing taxes could be interpreted as connecting elements that expand the meaning of citizenship or residence and are under the competence of the EU Member States. In contrast, the introduction of exit taxes and trailing taxes by individual EU Member States on the mere grounds of revenue loss would be incompatible with settled jurisprudence by the CJEU on the fundamental freedoms.[24] The CJEU would most probably accept exit taxes and trailing taxes on individuals if they would be adopted by a directive, especially after being recommended by an international organization such as the OECD.[25]

Furthermore, auditing whether declared residents are effective residents is also necessary, and instead of introducing taxation of citizens, it is preferable to eliminate *non-dom* regimes. Applying a Code of Conduct to personal income tax would allow auditing Member States' harmful tax competition.

Finally, rules that prevent double non-taxation could also be coordinated in a joint effort to prevent income shifting. Some of these rules are already a component of a number of tax treaties: the entitlement to benefits clauses are an example. They allow source countries to tax if the residence country does not tax an individual on the full amount of income (a switch-over clause).[26]

Ana Paula Dourado,
Editor-in-Chief.

Notes

20 Exit taxes often take the form of a capital gains tax against unrealized gains attributable to the period in which the taxpayer was a tax resident of the country in question.

21 This is done via legal fictions. For example, in the European Union, the Court of Justice decided on the compatibility of the following Netherlands legislation with the free movement of capital in the European Community Treaty. According to the Netherlands legislation at the time of the facts, '[a] Netherlands national who, having resided in the Kingdom, dies or makes a gift within 10 years after ceasing to reside there shall be deemed to have been resident in the Kingdom at the time of the death or of the making of the gift' (CJEU, 23 Feb. 2006, Case C-513/03, *Van Hilten*, EU:C:2006:131).

22 CJEU, 11 Mar. 2004, Case C-9/02, *De Lasteyr*ie, EU:C:2004:138.

23 CJEU, 23 Feb. 2006, Case C-513/03, *Van Hilten*, EU:C:2006:131.

24 .CJEU: 12 Dec. 2002, Lankhorst-Hohorst GmbH *v.* Finanzamt Steinfurt, Case C-324/00, para. 36, ECLI:EU:C:2002:749; 11 Mar. 2004; Hughes de Lasteyrie du Saillant *v.* Ministère de l'Économie, des Finances et de l'Industrie, Case C-9/02, para. 60, ECLI:EU:C:2004:138; 12 Sep. 2006, Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd *v.* Commissioners of Inland Revenue, Case C-196/04, para. 49, ECLI:EU:C:2006:544.

25 Directives have not been declared incompatible with the TFEU fundamental freedoms, due to the presumption of legality of the EU institutions acts and to institutional cooperation:Rita Szudoczky, The Sources of EU Law and their Relationships: Lessons for the Field of Taxation, Faculteit der Rechtsgeleerdheid, e.g., 8.3.4, 8.3.5 e 8.3.6; Dourado, 'The Relationship between Primary and Secondary EU Law in Tax Law: The Legitimacy of Different Interpretation Criteria Applied to EU and National Legal Sources', Traditional and Alternative Routes to EU Integration (ed. Dennis Weber), IBFD, 2010, at 171 e ss.

26 *See* e.g., Art. 28 (3) of the Tax treaty between Gibraltar and the United Kingdom entered into force on 24 Mar. 2020: '(3) Where under any provision of this Agreement, income or capital gains are relieved from tax in a territory and, under the laws in force in the other territory, an individual, in respect of that income or that capital gain is subject to tax by reference to the amount thereof which is remitted to or received in that other territory and not by reference to the full amount thereof, then the relief to be allowed under the Agreement in the first mentioned territory shall apply only to so much of the income or capital gain as is taxed in that other territory' https://assets.publishing.service.gov.uk/media/5e8dd67686650c18cb34ea4b/UK-Gibraltar_in-force_April_2020.pdf (accessed 1 Dec. 2024).