How do countries tax corporations?

This article is dealing with two important issues:

a) The basis to establish tax jurisdiction on corporate profits
b) The conflicts in tax jurisdictions

a) Basis to establish tax jurisdiction on corporate profits:

Any country, could establish a tax jurisdiction, in order to impose tax on a company's profits by connecting the company with its jurisdiction. The two most important tax connecting factors are: the *source connecting factor* and the *residence connecting factor*.

The source connecting factor:

The tax authorities of the country could claim tax jurisdiction in the case where the income was derived or earned by the company in its territory. To determine the source of an income, the country could apply two rules: the pay rule and the use rule. In accordance with the pay rule, the source country is the country where the payer of that income is having its tax residence. On the other hand, according to the use rule, the source country is the country in which the underlying assets related with the income, are situated.

The residence connecting factor:

The country will be able to claim tax jurisdiction if the company is a tax resident in its jurisdiction. Resident companies will be taxed on their worldwide profits in the country of tax residence. The tax residence of a company could be determined based on the 'domicile' of the company (place of incorporation), on the 'central management and control' test or on the 'place of management' test. Each country has its own definition of residence, which could occasionally create dual residence conflicts.

b) Conflicts in tax jurisdictions and double taxation:

'Juridical Double Taxation' arises when two countries are claiming jurisdiction to tax, in the same year, on the profits of the same company. That is mainly a result of a conflict between the connecting factors analyzed above.

Residence-to-Residence conflict: Both countries will claim the right to impose tax because in accordance with their domestic tax law, the company is a tax resident in their tax jurisdiction. For instance, the one claims the tax residence of the company because the company was incorporated in its jurisdiction and the other one because the company's central management and control is exercised in its jurisdiction.

Residence-to-Source conflict: Both countries will claim the right to impose tax because in accordance with their domestic tax law, the first country claims that the company is a tax resident in its jurisdiction, and the other one claims that the income is sourced in its jurisdiction. For instance, the one country claims the source of a capital gain because the assets disposed were located in its jurisdiction and the other country claims that the taxpayer that disposed the property is a tax resident in its jurisdiction.

Source-to-source conflict: Both countries will claim the right to impose tax because in accordance with their domestic tax law, the taxable income is sourced in their jurisdiction. For instance, the first country claims the source of the interest income because the paying company is a tax resident in its territory ('pay rule') and the other one because the mortgaged property ('use rule') related with the loan, is located in its territory.

To conclude, the conflicts in tax jurisdictions could cause double taxation which cannot always be resolved. A double tax relief goes to reduce the negative effects of double taxation, and it could be given by the residence country unilaterally through the relevant provisions of its tax law or bilaterally through the relevant provisions of a treaty.

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