

# ARTICLES

## Income Tax Treaty Policy in the 21st Century: Residence vs. Source

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### *Abstract*

*The United States has repeatedly attempted to stop tax base erosion for almost the entire post-World War I era, and yet the same problems exist today. The need for fundamental tax reform is front-page material in the major newspapers with the US transfer pricing rules and US multinationals portrayed as public enemy #1. The OECD this month issued a report entitled "Addressing Base Erosion and Profit Shifting," and in a competing fashion several important developing countries have initiated their own pact to develop cooperative strategies on these issues outside of the framework of the OECD and UN.*

*The attached manuscript studies the historical record and sets forth a competing model for dealing with these matters which pre-dated the existing model treaties and transfer pricing paradigm. This earlier paradigm was offered by the International Chamber of Commerce's but was prematurely abandoned by the League of Nations in favor of the existing paradigm. In light of the fact that the existing paradigm has failed so miserably, the earlier proposal should be re-considered.*

*In the inevitable re-examination process, there will be a fascinating range of political, economic, and business issues to be addressed. Tax administrations will need to ascertain how their resources could be redeployed to foster economic growth. MNEs will need to assess the impact of new treaty concepts on their global effective tax rate planning models.*

*The critical question is who will initiate the evolution to come. All countries are anxious to protect their respective tax bases. At the present time, it appears that the BRICS and Source Countries have planted their stake in the sand, rejecting the existing order and declaring an intention to update the rules that apply to their own tax base defense. The OECD appears to be principally driven by the need to defend its Member country tax bases, hoping, no doubt, that BRICS and Source Countries will ultimately follow its lead. Whichever organization emerges as the new-found thought leader on these questions, it is now time to give the original International Chamber of Commerce recommendation a fair consideration on its merits (which, interestingly, addresses the current concerns of BRICS and Source Countries).*

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## INTRODUCTION

It is rare that the global effective tax rate strategies of multinational corporations (“MNEs”) become priority topics for financial center newspapers and magazines. It is even rarer that such matters become features in the popular press; yet this has become commonplace in recent years. For example, a recent story declared that a prominent MNE’s 3.2 percent effective tax rate has put it “at the forefront of mounting political anger about multinationals that shift profits to low tax jurisdictions.”<sup>1</sup>

Not surprisingly, the tax authorities of the world, including the predominant inter-governmental or country groups, namely the Organization for Economic Cooperation and Development (“OECD”) and the United Nations (“UN”), have announced their intention to address these issues. For example, the European Commission has unveiled plans to “crack down on tax havens and aggressive tax planning by companies” as one means of helping EU states recover from their economic downturns.<sup>2</sup> Similarly, the G-8 and G-20 groups have asked the OECD to review applicable rules to reduce the ability of MNEs to shift profits (i.e., base erosion).<sup>3</sup> The OECD has responded by releasing a report that attempts to address the problems of base erosion and profit shifting but does so without fundamentally re-examining the existing tax treaty paradigm.<sup>4</sup> In the United States, treasury officials make similar declarations, advising that any broad tax reform must be focused on the base erosion fight.<sup>5</sup> There is

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<sup>1</sup> See Vanessa Houlder, *Google moves \$9.8bn revenues to Bermuda*, FIN. TIMES, Dec. 12, 2012, at 18 (“Google earns ‘substantially all’ its foreign income in Ireland, according to its annual report, but holds its non-U.S. intellectual property in Bermuda”), available at <http://www.ft.com/intl/cms/s/0/87c1f98a-4455-11e2-932a-00144feabdc0.html?siteedition=intl#axzz2hxqIluxB>. See also *Wake Up and Smell the Coffee*, ECONOMIST, Dec. 15, 2012, at 66; Szu Ping Chan, *Facebook Funneled Nearly Half a Billion Into the Cayman Islands Last Year*, The Daily Telegraph (Dec. 23, 2012), available at <http://www.businessinsider.com/facebook-ok-funneled-nearly-half-a-billion-pounds-in-the-cayman-islands-last-year-2012-12>; Rupert Neate, *Facebook paid £2.9m tax on £840m profits made outside US, figures show*, GUARDIAN (Dec. 23, 2012), available at <http://www.guardian.co.uk/technology/2012/dec/23/facebook-tax-profits-outside-us>; Charles Duhigg, *Inquiry Into Tech Giants’ Tax Strategies Nears End*, N.Y. TIMES (Jan. 3, 2013) (reporting that Congressional investigators are wrapping up an inquiry into the accounting practices of Apple and other technology companies that allocate revenue and intellectual property offshore to lower their US taxes), available at [http://www.nytimes.com/2013/01/04/business/an-inquiry-into-tech-giants-tax-strategies-nears-an-end.html?\\_r=2&](http://www.nytimes.com/2013/01/04/business/an-inquiry-into-tech-giants-tax-strategies-nears-an-end.html?_r=2&).

<sup>2</sup> See Joe Kirwin, *European Commission to Crack Down on Tax Havens, Corporate Loopholes*, DAILY TAX REP., Dec. 6, 2012, at I-2, available at Bloomberg BNA No. 234. In the case of Starbucks, it was so concerned about adverse publicity in the U.K. that it announced an intention to voluntarily not take deductions for royalties and other payments streams as a means of commencing a “process of enhancing trust with customers . . . .” See *An Open Letter From Kris Engskov, Managing Director of Starbucks Coffee Company UK*, STARBUCKS.COM (Dec. 6, 2012), <http://www.starbucks.com/blog/an-open-letter-from-kris-engskov/1249>. The making of such “voluntary adjustments” can create a wide-range of problems for all parties, including respective tax authorities. See Cym H. Lowell, Peter L. Briger & Mark R. Martin, U.S. INTERNATIONAL TRANSFER PRICING ¶ 4.02[3] (2012).

<sup>3</sup> See Kevin A. Bell, *G-20 Asks OECD to Review Rules With Goal of Curbing Profit Shifting*, DAILY TAX REP., Dec. 11, 2012, at I-1, available at Bloomberg BNA No.237.

<sup>4</sup> See *Addressing Base Erosion and Profit Shifting*, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2013), <http://dx.doi.org/10.1787/9789264192744-en>. This initial statement was followed in July 2013 with an OECD “Action Plan” for addressing the so-called homeless income or base erosion/profit shifting problem over an approximate two-year period. See *Action Plan on Base Erosion and Profit Shifting*, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2013), [http://www.keepeek.com/Digital-Asset-Management/oced/taxation/action-plan-on-base-erosion-and-profit-shifting\\_9789264202719-en](http://www.keepeek.com/Digital-Asset-Management/oced/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en).

<sup>5</sup> See *U.S. Reform Efforts Must be Informed by International Base Erosion Fight*, DAILY TAX REP., Dec. 11, 2012, at G-3, available at Bloomberg BNA No. 237

nothing new about such declarations, which have occurred repeatedly over the past fifty years.<sup>6</sup>

These comments largely relate to the concerns of the thirty-four OECD member countries. Non-governmental organizations and other interest groups working on behalf of emerging or developing nations are also concerned about this issue, fearing that global tax planning strips income from such countries.

At the same time, there has been controversy between non-OECD member countries concerning the defense of their own tax bases. This has occurred in the form of domestic tax policies of the so-called BRICS countries (Brazil, Russia, India, China, and South Africa, as well as other “source” countries). These countries have also objected with increasingly strident voices to the negative impact of the OECD/UN model income tax treaties on the economic health of their countries.<sup>7</sup>

These many voices chant a similar refrain of lament attributing economic malaise at the doorstep of MNEs. A reasonable observer, not sophisticated in global taxation matters, listening to this chorus would likely ask a series of questions seeking to get her bearings for a discussion of the issues. The first would be whether the press declarations are accurate as a matter of fact. The answer would likely be in the affirmative, in the sense that MNEs seek to move income from places where it could be deemed to have been earned, to a place where it would be taxed at a lower rate. It would likely be explained that tax is an expense like any other and business organizations must minimize their costs to remain competitive.

This answer would lead to the second question: are such MNE global tax strategies unlawful? The response would likely be that such policies are consistent with the international tax agreements throughout the twentieth century. Indeed, all countries have active tax enforcement mechanisms which routinely examine the affairs of even small and medium-size MNEs.<sup>8</sup>

Our thoughtful observer would then be confused, asking: “Hold on, I must be missing something. How can it be that these companies are so publicly criticized if they follow the law and are held to account in the very countries voicing the criticisms?” The respondent would likely answer with a shrug of shoulders and blank expression, ultimately advising “that is a good question.”

Indeed, the “what’s missing” element of the current debate is a fundamental matter that seems to be entirely lost in what is becoming a public crescendo of criticism pillorying MNEs and their tax planning arrangements as the bad guys in times of economic malaise. It is a drama that seems to grow in volume and intensity.

The purpose of this article is to provide explanation for the “what’s missing” question. As will be set out in detail below, the tension reflected in the current public dialogue is ultimately attributable to outdated treaty policy. Our model income tax treaties (both OECD and UN) were designed to minimize income that would be allocated

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<sup>6</sup> See Richard M. Hammer, Cym H. Lowell, Marc M. Levey, INTERNATIONAL TRANSFER PRICING: OECD GUIDELINES at ¶ 2.06[2] (2012) (describing the OECD so-called “Harmful Tax Competition” project) [hereinafter OECD TRANSFER PRICING].

<sup>7</sup> See OECD TRANSFER PRICING, *supra* note 6, at ¶ 12.01[5][a].

<sup>8</sup> Local tax authority enforcement is facilitated by cross-border income allocation documentation requirements in at least seventy countries. See OECD TRANSFER PRICING, *supra* note 6, at ¶ 10.05 and ch. 14 (discussing the requirements in each country).

to *source* countries, with the residue allocated to *residence* countries. This process occurred in the 1920s, immediately following World War I.

Needless to say, the world has changed in the interim, in politics, business practices, and in every other imaginable manner. The actual terms used to describe the respective countries in the debates of the 1920s are emblematic of the distance between then and now. The dialectic was framed in terms of the allocation of income (tax jurisdiction) between *Imperial* and *Colony* countries (meaning, respectively, England and India at the time). To a large extent, there has even been a reversal of roles in the intervening period of almost one hundred years. The Imperial countries (residence countries in treaty terms) have become Colonies (source countries in the same terms). Treaty policies intended to allocate income to the framers of the treaties actually now allocate income to other countries.

In other words, “what’s missing” is that: (i) no country seems to like the treaty rules which guide the allocation of income between countries; (ii) there is no movement to update those rules to reflect the economy of the twenty-first century as opposed to that of the early twentieth century; and (iii) MNEs have become the villains for these failures.

Accordingly, it is time to update the underlying treaty policy in a manner that will be accepted by all parties singing the current song of lament. At the end of the day, MNEs will abide by the rules that are established. In all likelihood, the principal request of MNEs would be for any evolution of such income allocation rules to be undertaken in a neutral manner so that all competitors are treated consistently. This work cannot be limited to a few decision-makers, as was the case in the 1920s when the current rules were developed. That group was composed of the victors of World War I who were also capital exporting countries, a small fraternity.

In this article, we begin by restating the foundational premise of our existing treaty and transfer pricing policies (Part I). We then examine the economic context of the immediate post-World War I world of the 1920s which spawned the policy premise (Part II), followed by evolution of the framework to address the needs of the policy-makers of that era (Parts III through VII). As the policy implementation occurred, it soon became apparent that there was a serious problem in the foundational premise (Parts IX and X). The flaw could have been addressed by an even earlier proposal, which continues to be a live international tax policy issue today. Finally, we suggest how the flawed foundational premise could be addressed to meet the needs of both countries and MNEs today (Part XII).

## I. EMERGENCE OF GLOBAL TENSION CONCERNING INTERNATIONAL TAXATION

The creation of global tax treaties was a critical international taxation evolution in the twentieth century. It will almost certainly be a center stage issue in the economic world of the twenty-first century. For the reasons noted above, the current model treaties of the OECD and the UN are based on the concept that residual income<sup>9</sup> for global income tax purposes should be allocated to the country of residence (“residence country”) of a MNE, and not to the country of the source of the underlying economic activity (“source country”). The allocation of income between residence and source countries is

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<sup>9</sup> For the purposes of this article, the term “residual income” refers to the portion of income earned by all parties to cross-border transactions (“combined income”) that remains after a routine return has been allocated to each of the related parties for the functions and risks that it performs (“residual income”). This is a concept that is rarely defined beyond certain TP contexts.

accomplished via the associated enterprise and related articles of the model treaties, commonly referred to as transfer pricing (“TP”), which principles have evolved over many years within this conceptual framework.

The origins of our existing treaty models are commonly traced to the work of the League of Nations (the “League of Nations”), which commenced in 1923, shortly following the cessation of hostilities in World War I.<sup>10</sup> An earlier model had been developed by the International Chamber of Commerce (the “ICC”) beginning in 1920. The ICC model reflected a different approach, which would have utilized a profit-split methodology for such allocation. In what now can be called a colossal mistake,<sup>11</sup> the ICC model was, beginning in 1923, rejected by the League of Nations in favor of the residence concept that became the base for the extant OECD and UN model treaties.

The allocation of taxation rights to residual income<sup>12</sup> has become a compelling treaty policy issue in the twenty-first century as tax base competition has arisen between: (i) source and residence countries; and (ii) tax authorities in every country and MNEs, as noted above. In addition, developing and emerging countries are in need of both tax revenue for economic growth, and defense of their own tax bases. International finance and non-governmental organizations have their own interests in facilitating growth in these countries. Finally, MNEs are the stakeholders in this process, often pilloried for their effective tax rate policies. The resulting tension surrounding the source country vs. residence country issue is ripe for global resolution.

As this process evolves, the ICC model may provide an interesting frame of comparative reference for the existing treaty models. Interestingly, the pre-League of Nations history has not been widely studied by scholars.

#### A. Foundational Premise of Our Treaty Networks

The primacy of residence in treaty policy has persisted through the global economic evolution of the post-World War II and Cold War eras. The consequence of this has been that residual income has typically been allocated to residence countries, while source countries have been left to collect withholding taxes on certain categories of income and assess net basis taxation only when an MNE’s activities created a permanent establishment in that country.

As the economies of the BRICS and other Source Countries matured in the late twentieth century, resistance to the subordination of source to residence as the means of allocating residual income has been reflected in the evolution of their domestic tax policies.<sup>13</sup> There have also been official statements rejecting the OECD TP principles and declaring the potential need for development of a new model treaty reflecting Source Country considerations. The resultant specter of double or multiple taxation to MNEs, and consequent need for relief via the mutual agreement procedures of bilateral treaties or

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<sup>10</sup> A discussion of the League of Nations model treaty and the development of the arm’s length standard is beyond the scope of this paper. For a thorough discussion of the genesis of these foundational premises to modern international tax law along with the substantial mischief that the adherence to these principles creates, see Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2012).

<sup>11</sup> As will be seen below, it was a colossal mistake because the League of Nations assumed that all countries would adopt the same tax policies and rates. See Parts XI and XII.

<sup>12</sup> See *supra* note 8.

<sup>13</sup> See OECD TRANSFER PRICING, *supra* note 6, at ¶¶ 2.06[4][a], 2.06[4][c], 12.01[5].

domestic foreign tax credit mechanisms, has given rise to tax base defense concerns of both MNEs and their residence countries.<sup>14</sup>

As will be developed below,<sup>15</sup> the League of Nations model was constructed from distinct policy judgments: (i) source country should tax local operations; (ii) residual income should be earned by the residence country; (iii) the presence of an interim holding company in a country should cause that country to be treated as a residence country; (iv) subsidiaries, by themselves, should not be treated as permanent establishments of the offshore parent company; and (v) TP is to be applied on a separate account basis (collectively, the “foundational premise”). As a consequence of these elements, the effective tax rate planning paradigm of MNEs has been to utilize the existing treaty and TP policies to earn a material portion of their combined income in low- or no-tax jurisdictions.<sup>16</sup> Taxation is a cost of doing business and, like all other costs, it is a critical element of competition in all industries that must be managed and controlled. What was envisioned as an allocation of taxing rights in favor of residence countries has resulted in the creation of “homeless income” (income that is not effectively taxed in either the source country or the ultimate residence country via full domestic net basis taxation).<sup>17</sup> The resultant perceived tax base erosion in both residence and source countries has been addressed by an ever-spreading range of domestic tax regimes (controlled foreign corporation, foreign tax credit, earnings stripping, and so on), as well as anti-avoidance principles, annual TP documentation requirements, aggressive examination techniques, and severe penalty policies.<sup>18</sup>

#### B. Homeless Income

While the foundational premise resulted in allocation of the primary right to tax residual income to residence countries, it also, ironically enough, spawned the phenomenon of homeless income. The irony is further heightened in the current period as these same residence countries have largely abandoned worldwide taxation of MNE activities.<sup>19</sup> This frames an interesting irony: the residence countries that established the foundational premise have largely eschewed taxation of extra-territorial income. The

<sup>14</sup> See OECD TRANSFER PRICING, *supra* note 6, at ¶ 12.04.

<sup>15</sup> See *infra* Parts III – VIII.

<sup>16</sup> See *Offshore Profit Shifting and the U.S. Tax Code: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Gov'tal Affairs*, 112th Cong. (2012). The global popular and financial press have also traced these debates. See, e.g., Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES, Apr. 29, 2012, at A1; John D. McKinnon & Scott Thurm, *U.S. Firms Move Abroad to Cut Taxes: Despite '04 Law, Companies Reincorporate Overseas, Saving Big Sums on Taxes*, WALL ST. J. (Aug. 28, 2012) available at <http://online.wsj.com/article/SB10000872396390444230504577615232602107536.html>.

<sup>17</sup> See Wells & Lowell, *Homeless Income and Tax Base Erosion*, *supra* note 10, at 537–38. See also Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy*, TAX NOTES INT'L, Oct. 29, 2012, at 499.

<sup>18</sup> A summary of the TP principles in each of more than 70 countries is collected in OECD TRANSFER PRICING, *supra* note 6, at ch. 14.

<sup>19</sup> The United States is now the last large major industrial country to not have a territorial tax regime. See Price Waterhouse Coopers, *PWC Reviews U.K. Finance Bill Provisions on Foreign Profit Repatriation*, 2009, available at Tax Doc. 2009-10308, 2009 WTD 87-22; see also Tom Neubig & Barbara M. Angus, *Japan's Move to Territorial Contrasts with U.S. Tax Policy*, 54 TAX NOTES INT'L 252, 252 (2009) (pointing out that the U.S. is becoming increasingly isolated). Others scholars have forcefully made the case that the United States' adherence to a worldwide tax regime, when all of its other major trading partners utilize a territorial tax regime, puts the United States out-of-step with the global economy and creates a significant competitive handicap. See Michael S. Knoll, *The Corporate Income Tax and the Competitiveness of US Industries*, 63 Tax L. Rev. 771, 771–72, 787–88, 793 (2010).

result is a windfall: income that is taxed nowhere by nobody. Our treaties were premised on the concept of allocating income to prevent double taxation, but the result is that they have achieved double non-taxation. The absurdity of the result should be the benchmark of the flaws in the existing treaty paradigm.

In other words, homeless income is a consequence of the foundational premise. Residence countries sought to extract residual income from source countries in the economic world of the 1920s. They also had a vision of common tax regimes in all countries. This did not occur, facilitating the evolution of interim holding companies in low tax countries. To top it off, the former residence countries have largely abandoned the taxation of extra-territorial income for their own tax base defense reasons, as they have become source countries themselves.

As noted in the introduction above, tension in the world of international taxation has grown. MNEs are routinely attacked for aggressive and effective tax rate planning techniques. The response of the MNE community has been, appropriately, that “we follow the rules that have been developed by public and private deliberations over a long period of time. If those policies are deemed to no longer articulate appropriate inter-governmental policies, then the time has come to develop new policies. We will be delighted to be active participants in this process. Our request is that common principles be applied to all competitors in the global economy.”<sup>20</sup>

The essential issue is that source countries, as well as residence countries that no longer seek to tax extra-territorial income, increasingly insist on taxing income based on the source of the underlying economic activity, not on the residence of the parent company (or interim holding company). There are at least three explanations for the current reality, which will be developed further through much this article:

1. *Post-World War I Politics*: The imposition of residence as an allocation criteria was largely a product of post-World War I international politics. The world has changed dramatically in the interim. Former “colony” countries are now economic powerhouses;
2. *Interim Holding Companies*: The residence concept had, from its inception, a serious flaw. It did not take into account interim holding companies in low tax jurisdictions; and
3. *One-Sided Transfer Pricing*: TP principles evolved on a one-sided basis –i.e., testing, typically, the “routine side” of transactional flows on the source country side, so that residual income would flow to the other side (the residence country side).<sup>21</sup>

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<sup>20</sup> In this regard, it is appropriate to note that in the proceedings of the U.S. Senate Permanent Subcommittee on Investigations hearings on *Offshore Profit Shifting and the U.S. Tax Code* in September 2012, there was roundhouse criticism of several prominent U.S. MNEs and their effective tax rate planning strategies. The MNEs had provided detailed information prior to the hearings. At the hearings, the MNE executives were candid. In essence, they advised that: (i) their tax strategies were designed to comply with existing global laws and regulations; (ii) meet competitive considerations relating to tax as a cost (i.e., a MNE cannot compete against a competitor with a materially lower effective tax rate, as tax is typically one of, or the highest, expense of companies); and (iii) openness to participate in a global process to develop new principles that will apply to themselves and their competitors. *Offshore Profit Shifting and the U.S. Tax Code*, *supra* note 16.

<sup>21</sup> In this context, “one-sided” TP methodologies test the financial results of related party transactions by focusing on one party to the transactions and the financial results of that party, as opposed to a “two-sided” analysis that would focus on both or all parties to the transaction and their combined income



As a result of these factors, many MNEs experience the following attitude of tax authorities in Source Countries: “If you want to do business in my country, you will pay tax on my terms; if you do not like my terms, do not come to my country; others will take your place.”

### C. Development of a Current Treaty Model

The political and economic tension surrounding international taxation principles in the early twenty-first century is ripe for resolution. Just as the world needed to prepare for new realities following World War I, today there is genuine need to reexamine tax policy determinations to assure that there is reasonable balance to achieve the international economic and taxation goals of the world for the current millennium.

The issues that will need to be addressed in such a process are appropriately framed by the positions of the groups that play important roles in the current international taxation world.

There are at least six groups with distinct voices:

1. *OECD*: traditionally composed of developed countries, which sponsors the Model Tax Treaty and Commentary, together with Transfer Pricing Guidelines, that are the standard of the world.
2. *UN*: often assisting developing or emerging countries, which has just issued its own transfer pricing manual intending to consistently apply the OECD Guidelines for the benefit of developing/emerging countries (i.e., source countries).<sup>22</sup>
3. *World Bank, Non-Governmental Organizations (“NGOs”), and Related Group*: often speaking on behalf of emerging countries and their need for tax revenue to continue development.
4. *ICC*: composed of both residence and source countries, which undertook the initial modern treaty formulation process in 1920.
5. *BRICS and Developed Source Countries*: not happy with principles of either OECD or UN, and certainly no longer emerging countries.
6. *MNEs*: are stakeholders. Their fiduciary responsibility to shareholders and investors, as well as their duty to residence and source countries, is to conduct business, including payment of tax, in accordance with internationally agreed upon rules and norms of conduct as implemented in the respective countries in which they conduct business. They must also responsibly address the reality that tax is a major cost and competitors often enjoy comparative advantage in applicable taxation regime.

In this article, we trace the evolution of the current model income tax treaty framework from its origins in 1920. Much of the actual history has been buried in the archives of the ICC and League of Nations. When the debates of the 1920s are viewed from the vantage point of the early twenty-first century economic world, and the

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relating to such transactions. The significance of these methodologies is developed in Part II.A *infra*, via an illustration.

<sup>22</sup> See UNITED NATIONS, PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES (2012).

disparate voices of residence and source countries, we draw two conclusions. First, the issues debated in the 1920s remain vital today. Second, those issues are in desperate need of being revisited and reformulated to restore balance for the future. Today there is far more controversy surrounding international taxation and TP than is necessary to assure reasonable allocation of taxing jurisdiction among all countries to facilitate global job creation and economic growth.

As is often the case, study of the historic evolution of our international tax treaty principles may provide illumination for the future, including answering the “what’s missing” question noted in the introduction.

## II. MERCANTILIST PARADIGM IN THE POST-WORLD WAR I PERIOD

When we examine the origins of current tax treaty policy, we need to imagine the world as it was in the 1920s. The paradigm of commerce and international taxation was a company resident in a residence country (let’s call it “ImperialCo”) with an affiliate in an under-developed source country that was a colony of the residence country (“ColonyCo”). A global war just ended, with the residence country having enormous debt. There was a material flow of commerce between the ImperialCo and ColonyCo. For the most part, the former transferred to the latter capital, technology, and access to global markets. ColonyCo responded by producing commodities and goods for ImperialCo and its global markets. The residence country was a creditor and the source country a debtor.

More specifically, the situation could be described as follows:<sup>23</sup>

*ImperialCo* is incorporated and has its home office in England. The year is 1925. *ImperialCo* is in the textile business requiring a ready supply of cotton, a raw material not grown in England. *ImperialCo* has a global organizational structure with subsidiaries based within the cotton-producing British Commonwealth countries such as India. It also has manufacturing facilities in important commercial regions of the world (India and elsewhere), as well as shipping companies that transport raw materials and finished products to global commercial markets. All these operations are based in the colonies, with affiliates conducting business using capital and technology provided by *ImperialCo*. In return, the affiliates pay interest and royalties to *ImperialCo*, which are deducted for colony income tax purposes. To the extent that excess cash remains in colony affiliates after local expenses and taxes, such income is distributed to *ImperialCo* via dividends.

The policy issue for consideration was how income from these activities (functions and risks) should be shared between ImperialCo and ColonyCo or, in today’s terms, the residence and source countries. As will be developed below, the framework of taxation that evolved in the 1920s was based on the mercantilist belief that imperial countries were the source of capital and know-how while the colonies were passive suppliers of goods or services with little value added functionality. As a result, the right to tax residual income belonged to the residence countries of the imperial companies (England in this example). Source countries (India in the example) were allowed to tax

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<sup>23</sup> The following hypothetical is adapted from Mitchell B. Carroll, *Allocation of Business Income: The Draft Convention of the League of Nations*, 34 COLUM. L. REV. 473 (1934) (giving example of cotton and other goods produced in India to be sold abroad).

only routine profits deemed earned therein and impose withholding taxes on certain types of outbound payments.

The tax planning strategies of *ImperialCo* utilized in this mercantilist paradigm would likely be along the following lines:

*Raw materials* (raw cotton) or processed goods would be purchased from the colony country company ("*IndiaCo*") at the lowest price possible consistent with providing *IndiaCo* the capital needed to continue operations ("supply chain transactions").

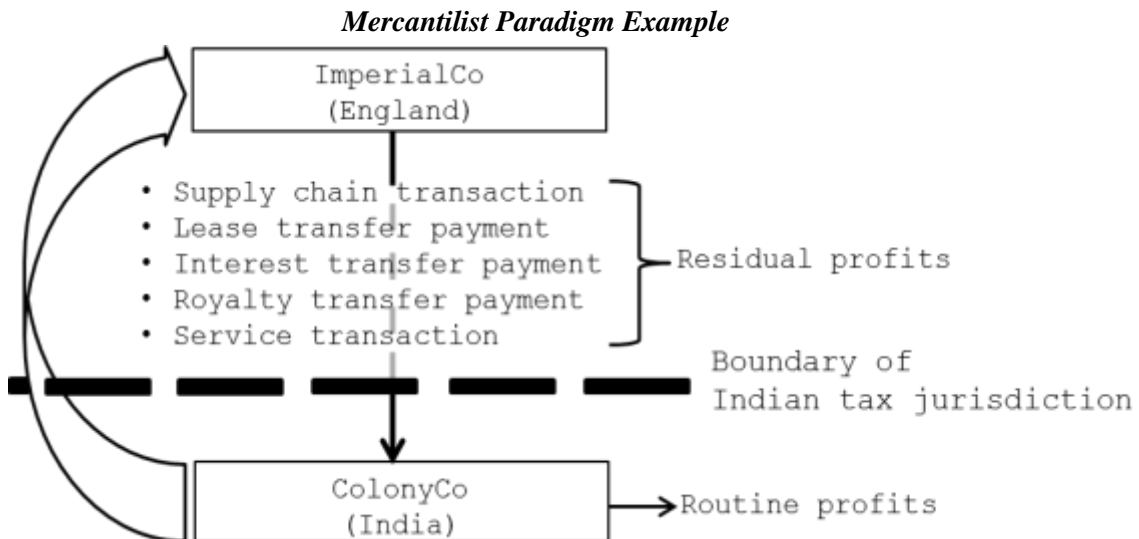
*Movable tangible property* (machinery and equipment) could be leased by *ImperialCo*, with leasehold payments made by *IndiaCo* ("lease transfer payments").

*Capital* could be provided via loans from *ImperialCo*, with interest payments made by *IndiaCo* ("interest transfer payments").

*Know-how* to the extent required could be provided in the form of licenses with royalties paid by *IndiaCo* ("royalty transfer payments").

*Services* provided by *ImperialCo* would be paid for via service fees ("service transactions").

The net result of these transactions was that *ImperialCo* would have the ability to transfer the residual Indian profits out of India at a minimal Indian tax cost, leaving only routine operating profits in *IndiaCo*. These arrangements can be depicted as follows:



#### A. Application of Foundational Premise

Much of what can be drawn from the following study of the origins of our current model treaties concerns the evolution of the elements of the foundational premise. Before undertaking that discussion, it is appropriate to frame the mercantilist paradigm in a manner to reflect the current structure and TP policies of many MNEs which, in turn, produces much of the tension in our international taxation world.

For this purpose, assume that *ImperialCo* has formed an interim holding company ("*HoldCo*") in a country having a broad treaty network and low domestic income tax rates (let's call it "*Holdland*"). The "residual profits" ("residual

income”)<sup>24</sup> noted above are earned by HoldCo. Assume further that ColonyCo has net sales of 1,000X and incurs costs of 100x in conducting its operations in India, excluding any lease, interest, royalty, or service fees (the “related party payments”) paid to related parties (HoldCo for purposes of discussion). For Indian TP purposes, it is determined that the appropriate TP method to test the margin of ColonyCo is the cost plus method, and that the arm’s length “plus” is 5%; this is a one-sided transfer pricing method in the sense that the testing is limited to the income that should be received by ColonyCo for TP purposes.<sup>25</sup>

This would mean that the financial results of ColonyCo’s activities prior to consideration of the residual income (ultimately allocated to HoldCo) would be as follows:

**ILLUSTRATION A**

	<b>ColonyCo</b>
Net sales	1,000
Operating expenses	<u>– 100</u>
Net income	900

Under the TP method, ColonyCo is entitled to earn 5% on its operating expenses, which would mean that its share of the net income would be 5. The balance of the net income (900 – 5 = 895) would be allocated to HoldCo and paid via the Related Party Payments.<sup>26</sup> The allocation of income between the parties would be as indicated in *Illustration B*:

**ILLUSTRATION B**

	(1)	(2)	(3)
	<b>ColonyCo</b>	<b>HoldCo</b>	<b>Combined</b> <sup>27</sup>
Gross Income	1,000	895	1,000
Operating expenses	<u>– 100</u>	<u>0</u>	<u>– 100</u>
Related party payments	<u>– 895</u>	<u>0</u>	<u>0</u>
Net income	5	895	900

As noted in Part I.A, above, the foundational premise had several elements. In the context of the *Illustration B*, these elements are as follows:

- (i) Source country should tax local operations: this is reflected in Column (1) above;

<sup>24</sup> See *supra* note 8.

<sup>25</sup> The cost plus method is a one-sided transfer pricing method test, meaning that the arm’s length return of ColonyCo is determined by testing its functions by margins earned by uncontrolled companies performing similar functional activities, which is easily obtained from data bases of public companies. See OECD TRANSFER PRICING, *supra* note 6, at ¶ 4.04. Such methods are the means by which most TP is typically undertaken, especially for documentation purposes in the 70+ countries that require such documentation.

<sup>26</sup> For purposes of this illustration, we are ignoring how the related party payments would be characterized under the India – Holdingland treaty, which could have other consequences, such as Indian withholding taxes. We are also ignoring all other taxation matters, such as consumption tax or application of outbound payment limitations under India law.

<sup>27</sup> The combined income is an aggregate of the separate income of ColonyCo and HoldCo. See *supra* note 8. For such purposes, the related party payments are ignored.

- (ii) Residual income should be earned by the residence country: this is reflected in Column (2) above;<sup>28</sup>
- (iii) Presence of an interim holding company should be treated as a residence country: this is also reflected in Column (2) in the sense that HoldCo is entitled to receive the residual income);
- (iv) Subsidiaries should not be treated as permanent establishments: achieved by the segregation of Column (1) from Column (2) for Indian tax purposes; and
- (v) TP is to be applied on a separate account basis: achieved by acceptance by the source country (India) of the results of elements (i) – (iv)

The results in *Illustrations A and B* reflect a disconnect between the allocation of income and economic reality. Residual income arising from economic activities in source countries like India is allocated away from them. If the resident country were to tax such income, then this misallocation would not create double non-taxation, but resident countries are increasingly unlikely to tax extra-territorial income. The TP policies developed in the mercantile era thus achieve results in today's reality that were probably not anticipated. As will be developed in the proceeding pages, source countries are in the process of seeking a solution to this state of affairs. A review of the past and the decision points that have led to the current situation in international tax policy provides guidance for a way forward.

### III. BIRTH OF TWENTIETH CENTURY MODEL TAX TREATY POLICY

World War I ended in November 1918. In that world, all countries had crushing debt burdens and sought to impose taxes wherever possible. The danger of double or multiple taxation was a significant concern of businesses and governments.

The ICC was formed in Paris in 1919 to promote trade and investment, open markets for goods and services, and facilitate the free flow of capital.<sup>29</sup> One of the foundational elements of the ICC was the elimination of double taxation as indicated in the following early resolution:

RESOLVED, That the International Chamber of Commerce, in meeting duly assembled, composed of representatives of commercial and industrial organizations of the allied countries [victors of World War I],

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<sup>28</sup> For this purpose, residual income is the share of combined income (Column (1) + (Column (2))) remaining after allocating to the TP tested party (ColonyCo in this illustration) its income applying an appropriate one-sided TP method (Column(1) using the cost plus method). One potential view of residual income is that it must be attributable to something. But what is it? Perhaps its existence testifies to the failure of accounting concepts to reflect economic reality. In this view, if we knew better what the *something* was we could design accounting policies to accurately reflect its allocation and where it should be taxed. In our own view, the *something* is simply the obvious flaws in the Foundational Premise and current model treaties and their implementing TP policy.

<sup>29</sup> See *The merchant of peace*, INTERNATIONAL CHAMBER OF COMMERCE, <http://www.iccwbo.org/about-icc/history/> (founded by a "group of industrialists, financiers and traders . . . determined to bring economic prosperity to a world that was still reeling from the devastation of World War I. They founded the International Chamber of Commerce and called themselves 'the merchants of peace'. The world had few working international structures in the immediate aftermath of the first of the 20th century's global conflicts. There was no world system of rules to govern trade, investment, finance or commercial relations. That the private sector should start filling the gap without waiting for governments was ground-breaking. It was an idea that took hold.") (last visited Nov. 10, 2013).

urge prompt agreement between the Governments of the allied countries in order to avoid that individuals or companies of any one country may be liable to more than one tax on the same income, taking into consideration that the country to which . . . such company belongs has right to claim the difference between the tax paid and the home tax.<sup>30</sup>

The ICC focused on the double taxation issue as the League of Nations organized its own efforts.<sup>31</sup> The ICC's initial assembly was held in Paris in June 1920,<sup>32</sup> which adopted a resolution that "Governments of the allied countries should speedily come to international agreements, in order to prevent . . . companies from being compelled to pay tax on the same income in more than one country."<sup>33</sup> The first ICC Congress was held in London on June 27 to July 1, 1921.<sup>34</sup> Double taxation was one of the first subjects addressed by the ICC.<sup>35</sup> The ICC considered a set of principles that were debated and ultimately revised.<sup>36</sup>

<sup>30</sup> International Chamber of Commerce, *Congress of London 1921*, brochure 11, at 3 (Brochures 1–16, available from ICC Paris Archives) [hereinafter *1921 ICC Proceedings*],. See generally Michael J. Graetz & Michael M. O'Hear, *The 'Original Intent' of US International Taxation*, 46 DUKE L.J. 1021, 1066–74 (1997) (addressing the original ICC work as an element of the need for reform of the U.S. international taxation system).

<sup>31</sup> There was contact between the ICC and the League, including overlapping membership in the double taxation committees. See International Chamber of Commerce, *Double Taxation (Survey of the Work of the I.C.C. Since the Rome Congress)*, brochure 34, at 10 (describing the Brussels Third Congress, June 21–27, 1925) [hereinafter *1925 ICC Proceedings*].

<sup>32</sup> See *Business Men Go Abroad*, N.Y. TIMES, June 6, 1920.

<sup>33</sup> International Chamber of Commerce, *ICC Second Congress Rome*, brochure 25, at 14 (Mar. 18–25, 1923) [hereinafter *1923 ICC Proceedings*].

<sup>34</sup> The proceedings are documented in the 1921 ICC Proceedings brochures. Contemporaneous news accounts explained the significance of the meetings. See *Favor World Board to Facilitate Trade*, N.Y. TIMES, June 20, 1921 (attendees to create "a permanent International Committee charged with ironing our difficulties arising in the exchange of goods between nationals of different countries . . .").

<sup>35</sup> *1921 ICC Proceedings*, supra note 30, brochure 11 (Part I), at 3. The Committee was composed of delegates from Belgium, France, Great Britain, Italy, Netherlands and the United States (John B. Robinson of Coudert Brothers, Paris, and Robert Grant, Jr., Lee Higginson & Co.). *Id.*

<sup>36</sup> *1921 ICC Proceedings*, supra note 30, brochure 11 (Part I), at 5. (The originally proposed principles were edited, with deletions ~~crossed through~~ and added language underlined) as follows:

1<sup>st</sup> Principle.

~~As With~~ regards ~~to the taxation of~~ income gained in ~~earned and collected within~~ the country, ~~from whatever its derived~~ (real estate, personal or property, business and professionals), each nation should apply ~~without prejudice to the question of super tax~~<sup>36</sup> (~~impôt global~~) on income, each country should accord similar treatment to all its tax-payers, whether nationals or both citizens and foreigners, whether resident or non-resident in the country or not.

2<sup>nd</sup> Principle.

~~As With~~ regards ~~to the taxation~~ on incomes ~~earned and collected abroad, from whatever its derived~~ . . . , apart from the question of a total tax on the ~~without prejudice to the super tax~~ (~~impôt global~~) on income, each nation country should apply accord similar treatment to all tax-payers subject to this tax (i.e. national citizens or foreigners living resident in the country, nationals living and citizens resident abroad); if this class of income, if total exoneration is not possible, cannot be entirely free from liability to taxation, it should be allowed a big reduction, given the fact that it has already been taxed in the country of origin the object of a considerable rebate in consideration of the tax on such income already levied in the country of origin.

This principle is already followed in force in certain countries (for example, in Belgium, for example, where total relief comes to as much as the rebate amounts to 80%, and in the United States, where the total relief rebate is granted total in cases of reciprocal treatment).

....

In the proceedings,<sup>37</sup> the U.S. representative (W.F. Gephart) expressed concern about the first principle (place of collection of tax) since “this can be fixed or determined at the desire or option of the taxpayer . . . Liability to taxation should not depend upon a characteristic so subject to manipulation.”<sup>38</sup> A British representative (Sir Algernon Firth) urged that “tax should be levied where the income is earned . . . .”<sup>39</sup> At the end of the discussion, it was agreed that the focus was to achieve “no double taxation.”<sup>40</sup> There was also agreement that a Committee on Double Taxation would be assembled, and Professor Thomas Sewall Adams from the United States was selected to serve on this committee for the United States.<sup>41</sup>

The Second Congress was held in Rome in 1923.<sup>42</sup> The proceedings noted that additional meetings had been held in the interim, including contacts with the financial Commission of the League of Nations.<sup>43</sup>

In these early discussions, the bedrock principle was that where a company does business in more than one country:

1. The profits should be taxed in each country in proportion to the profit realized therein (paragraph 8 of the ICC draft 1923 resolution);<sup>44</sup>
2. If the countries cannot agree, then the allocation would be presumed to be proportional to sales (turn-over) (paragraph 9 of the ICC draft 1923 resolution);<sup>45</sup> provided that
3. In no case should such proportions exceed the total fixed by the “competent authority in the country of domicile” (residence) (paragraph 10 of the ICC draft 1923 resolution).<sup>46</sup> In other words, the ICC

*3<sup>rd</sup> Principle.*

~~As With regards total income tax on all categories to the super tax (*impôt global*) on income of every class . . . it is desirable that each nation country should only levy one tax only foreigners living within its territory, which should only apply to the total income actually earned in the country, excluding income earned in other countries its own citizens without regard to their place of Residence.~~

~~In cases where certain countries cannot adopt the solution they should at least refrain from taxing foreigners resident within their frontiers except by tax applicable solely to the total income earned in the country itself apart from income earned in other countries.~~

*4<sup>th</sup> Principle.*

~~It is advisable desirable to see the above mentioned principles given above applied to both individuals and corporate bodies companies, etc., in the same manner as individuals.~~

. . . .

The principles were then explored in terms of the laws of each of the participating countries.

<sup>37</sup> The US representatives in the proceedings were Willis H. Booth, John H. Fahey, Edward A. Filene, William Butterworth, Harry Wheeler, and Owen D. Young.

<sup>38</sup> *1921 ICC Proceedings*, *supra* note 30, brochure 18 (Part I), at 58.

<sup>39</sup> *Id.* at 61.

<sup>40</sup> *Id.* at 62.

<sup>41</sup> *1921 ICC Proceedings*, *supra* note 30, brochure 19 (Part I), at 13. Other members were Sir Algernon F. Firth (Great Britain), Mr. O.E. Bodington (Great Britain), Dr. J. Ph. Suyling (Netherlands), Dr. J.E. Claringbould (Netherlands), Robert Grant, Jr. (United States), W.F. Gephart (United States), and Jerome Green (United States). The role of Adams is discussed extensively in Graetz & O’Hear, *supra* note 30, at 1027–33.

<sup>42</sup> The US representatives were, as noted above, appointed in 1921, as well as J.B. Robinson, a barrister, who had been active in 1921 as well.

<sup>43</sup> *1923 ICC Proceedings*, *supra* note 33, brochure 25, at 16.

<sup>44</sup> *See 1923 ICC Proceedings*, *supra* note 33, brochure 23, at 34–35.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

recognized that the combined income of the enterprise would need to be allocated, ultimately on the basis of proportional sales if the countries could not otherwise agree, and subject to agreement by the country of residence (domicile).

The above proposed profit-split (or formulary apportionment) approach starts with the basic idea that both countries, the residence country and the source country, have a co-existent interest in the combined income. Instead of assigning all rights over that income to one country or another, the above framework sought to ensure that an allocation would be agreed by both countries. They would have flexibility to vary the profit-split methodology, subject to a default formulary apportionment rule in the event that agreement could not be reached. The premises behind this ICC proposal were that: (i) the MNE was simply a stakeholder and should not bear double taxation; and (ii) residual income should be allocated between the countries on a proportional basis.

In the discussions leading to the ICC proposal, it was recognized the existence of separate fiscal regimes in each country was a fundamental problem.<sup>47</sup> While the problem of allocation of taxing jurisdiction could be resolved by the introduction of uniform fiscal legislation among all countries, this was renounced as “utopian.”<sup>48</sup> The only practical response to the double taxation risk in the context of the sovereignty of each country was to provide a framework that sought to assure that income should only be taxed once. The issue, then, was to determine “what constitutes the right of one country to tax the income of a taxpayer in preference to any other country.”<sup>49</sup> The following statement at the time framed the issue well:

It does not seem probable that there would be serious difference of opinion on this matter. A wide-spread view considers that the country from whose territories the income is derived should in every case have the right to levy a tax thereon. At the same time it is agreed that as regards income derived elsewhere, the country of domicile should have the privileged position.<sup>50</sup>

The ICC delegates contemplated that if a profit-split methodology were accepted by countries under the auspices of the League of Nations, the principles would be more likely to be readily accepted by the member nations in their national laws of the countries.<sup>51</sup> In addition, it was hoped that a set of regulations would be developed by an “international fiscal commission” along with an administrative appeal process in the country or as an international commission with national court or international court or arbitration review ultimately available.<sup>52</sup>

The proceedings noted that guidance had been obtained from a variety of sources, including the Rome Convention between the Succession States to the Austro-Hungarian Empire in 1921 (the “1921 Austro-Hungarian Treaty”),<sup>53</sup> though uncertainty

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<sup>47</sup> The same is true today as countries attempt to protect their tax base and attack the homeless income problem with ad hoc domestic responses.

<sup>48</sup> See *1923 ICC Proceedings*, *supra* note 33, brochure 25, at 8.

<sup>49</sup> *Id.*

<sup>50</sup> See *1923 ICC Proceedings*, *supra* note 33, brochure 25, at 8. As indicated from the above excerpt, the ICC contemplated that a system of credits be established between countries except that no country would be expected to give up via foreign tax credit relief more than “half the amount that it could have gained had the income been derived from its own territory.” *Id.* at 9.

<sup>51</sup> *Id.* at 11.

<sup>52</sup> *Id.* at 12–13.

<sup>53</sup> *Id.* at 16, 19, 49–52 (including the text of the treaty).



as to the definition of critical terms (such as “domicile”) would need to be addressed. It was recognized that:

The necessity for regulating double taxation by means of international conventions becomes more and more apparent, as different countries replace their taxes on real estate by personal taxes on income and fortune.<sup>54</sup>

In the 1923 discussions, there was a preference for providing that “only income acquired in the country should be affected [subjected to tax by such country],” though there was recognition that national regimes would differ and perhaps a rebate system would be appropriate (such as the foreign tax credit system recently adopted in the United States).<sup>55</sup> Interestingly, the proceedings included a copy of the 1921 Austro-Hungarian Treaty, which explicitly provided for: (i) taxation by the residence country; and (ii) where there was a presence in another country, each country shall tax the portion of the income produced in its borders.<sup>56</sup>

The final element of the Second 1923 Congress was a request from the United States that no formal resolution be adopted, since it had, late in the day, submitted reservations. Accordingly, the “question of Double Taxation [was] referred for further study.”<sup>57</sup>

#### A. Application of ICC Approach to the Mercantilist Paradigm

If the ICC approach had been developed as the theoretical base for treaty income allocation, as opposed to the Foundational Premise noted in *Illustration B* above,<sup>58</sup> the results would have been entirely different. Instead of receiving only a cost plus 5% return using a one-sided TP method, the return to ColonyCo would be determined by the two-sided TP method testing the combined income.

For this purpose, assume that the applicable principles are as noted above from the ICC proceedings<sup>59</sup> and that India and Holdingland have agreed that the allocation of the combined income between ColonyCo and HoldCo should be 50:50 (based on pertinent factors, perhaps including “sales”).<sup>60</sup> The results would then have been as indicated in *Illustration C*:

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<sup>54</sup> *Id.* at 19.

<sup>55</sup> *Id.* at 46.

<sup>56</sup> See 1921 Austro-Hungarian Treaty art. 4, in *1923 ICC Proceedings*, *supra* note 33, brochure 25, at 50, which provided as follows:

Income derived from the exercise of any kind of trade or industry is taxed by the State in whose territory the *industrial* or *commercial* undertaking has its registered office, even when the latter extends its activities into the territory of another contracting State.

If the enterprise has its registered office in one of the contracting States, and in another has a branch, an agency, an establishment, a stable commercial organization, or a permanent representative, each one of the contracting States, shall tax that portion of the income produced in its own territory. Therefore the financial authorities of the interested states shall be able to request the tax-payer to hand in general balance-sheets, special balance sheets, and all other documents required by the laws of the said States.

<sup>57</sup> See *1923 ICC Proceedings*, *supra* note 33, brochure 32, at 136.

<sup>58</sup> *Id.* at Part II.A.

<sup>59</sup> *Id.* at Part III.

<sup>60</sup> We note that scholars have suggested approaches similar to the ICC proposal. See, e.g., Reuven S. Avi-Yonah, Kimberly A. Clausung & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

## ILLUSTRATION C

	(1) ColonyCo	(2) HoldCo	(3) Combined
Net sales	1,000	450	1,000
Operating expenses	<u>- 100</u>	<u>0</u>	<u>- 100</u>
Related party payments	<u>- 450</u>	<u>0</u>	<u>0</u>
Net income	450	450	900

Several comments are in order at this point. The ICC proposal provided flexibility for countries to refine the default result set forth above. Thus, the ICC approach was flexible enough to allow a functional analysis to be performed to ensure that the functions actually and substantively performed in the HoldCo jurisdiction did in fact provide the value contribution assigned to them in the apportionment methodology.

If India and Holdingland had entered no such agreement, then ColonyCo, under the ICC approach, would have had to report income in India using the default mechanism (such as relative sales).<sup>61</sup>

#### B. Continuation of the ICC Work

Unfortunately, the promising approach originally advocated by the ICC was scuttled. As the ICC work evolved, the League of Nations was getting organized. The ICC was in continuing contact with the League, “which is carrying on its work [in these matters], but which has not yet succeeded in collecting the reports which it has entrusted to all known economists.”<sup>62</sup> The approach endorsed by the League of Nations evolved into a different framework for handling the problem of international double taxation.

#### IV. ENTRY OF THE LEAGUE OF NATIONS<sup>63</sup>

The Covenant of the League of Nations was signed on June 28, 1919, and entered into force on January 10, 1920.<sup>64</sup> Work on income tax treaties commenced immediately.<sup>65</sup> The Fiscal Committee of the League of Nations commissioned four economists to study the double taxation problem.<sup>66</sup> These economic experts faced the same conundrum as the ICC had: the allocation of taxing jurisdiction between countries.

The economic experts framed the issue more specifically than had the ICC First and Second Congress and stated that the issue involved a conflict of interest between debtor (capital importing) countries and creditor (capital exporting) countries.<sup>67</sup> Edwin R.A. Seligman (one of the four economists) explained the tension that faced these early thinkers in the following terms:

<sup>61</sup> A continuing conceptual issue will remain how that 450 million, which is homeless income in the context of *Illustration C*, should be taxed. We review a variety of perspectives on this issue in Part XII.F., *infra*.

<sup>62</sup> See *1923 ICC Proceedings*, *supra* note 33, brochure 25, at 16–17. The League’s economic experts were appointed in February 1921. See *1925 ICC Proceedings*, *supra* note 31, brochure 34, at 10.

<sup>63</sup> See generally Bret Wells & Cym Lowell, *supra* note 10.

<sup>64</sup> See Treaty of Peace with Germany (Treaty of Versailles), U.S.-Ger., June 28, 1919, 2 Bevans 43.

<sup>65</sup> JOHN G. HERNDON, RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROcity FOR THE PREVENTION OF DOUBLE INCOME TAXATION 42 (1932).

<sup>66</sup> See *1923 ICC proceedings*, *supra* note 33, brochure 25, at 16.

<sup>67</sup> League of Nations Econ. & Fiscal Comm., *Report on Double Taxation Submitted to the Financial Comm.*, 39-41, 48-49, League of Nations Doc. E.F.S.73.F.19 (1923) [hereinafter *1923 Economic Experts Report*].

If all the states in the world were in the same relative stage of economic and fiscal development the situation [for reaching agreement on the means to avoid international double taxation] would be far simpler. But under the present conditions some countries are more or less adequately supplied with capital, while others are still in the earlier stages of industrial development. The economic world today is therefore divided into creditor and debtor countries . . . What would be perfectly easy for a creditor state to adopt might be entirely unacceptable to a debtor state.

What is true of the obvious conflicting interests in question is also seen when we consider the less obvious but none the less important consequences of a tax system.<sup>68</sup>

On April 5, 1923, the economists issued their report.<sup>69</sup> It posited that double taxation should be avoided by vesting the primary taxing jurisdiction in the country to which the taxpayer owed its “economic allegiance.”<sup>70</sup> It identified the following four factors for determining economic allegiance: (1) origin of wealth, (2) situs of wealth, (3) place of enforcement rights to wealth, and (4) where wealth was consumed.<sup>71</sup>

The report then analyzed four possible approaches for avoiding international double taxation:

(Option 1) Country of residence would concede all taxing jurisdiction to the source state;

(Option 2) Country of source would concede exclusive taxing jurisdiction to the residence state;

(Option 3) Proportional allocation of income between the countries of residence and source; or

(Option 4) Classification of income and an assignment of the primary right to tax such income to the country of residence or source depending on the type of income (the so-called “classification-and-assignment approach”).<sup>72</sup>

The report unanimously ruled out Option 1’s approach of conceding all taxing jurisdiction to the source country because this violated ability-to-pay principles.<sup>73</sup> Remarkably, the report expressed a preference for Option 2’s approach of exempting all income of a nonresident from any source country taxation and thus ceding all taxing jurisdiction to the country of residence.<sup>74</sup> But the report anticipated that this recommendation would be difficult to adopt because it created an enormous disadvantage to debtor countries,<sup>75</sup> so the report offered as a secondary alternative the recommendation to classify income into various categories and then to assign taxing jurisdiction based on the classification (Option 4, the classification-and-assignment approach).<sup>76</sup> After discussing its rationale for which jurisdiction should have the primary right to tax each category of income,<sup>77</sup> the report summarized its allocation of taxing jurisdiction for each category of income in the following manner:

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<sup>68</sup> EDWIN R.A. SELIGMAN, *DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION* 14–15 (1928).

<sup>69</sup> *1923 Economic Experts Report*, *supra* note 67.

<sup>70</sup> *Id.* at 20–22.

<sup>71</sup> *Id.* at 22–27.

<sup>72</sup> *Id.* at 40–42.

<sup>73</sup> *Id.* at 48.

<sup>74</sup> *Id.* at 48, 51.

<sup>75</sup> *Id.* at 48–49. In fact, developing countries in twenty subsequent years proposed their own model tax treaty that would repudiate Option 2 and opt for Option 1, thus advocating the exact opposite position as the one endorsed by the 1923 Economic Experts Report. See Part VII, *infra*.

<sup>76</sup> *Id.* at 49–51.

<sup>77</sup> *Id.* at 27–38.

TABLE<sup>78</sup>

Category of Wealth		Preponderant Element	
		Origin <sup>79</sup>	Domicile <sup>80</sup>
I.	Land	X	
II a.	Mines, oil wells, etc.	X	
II b.	Commercial establishments	X	
III a.	Agricultural implements, machinery, flocks, and herds	X	
III b.	Money, jewelry, furniture, etc.		X
IV.	Vessels	X (regist)	
V a.	Mortgages	X (prop'y) (income)	X
V b.	Corporate shares		X
V c.	Corporate bonds		X
V d.	Public securities		X
V e.	General credits		X
VI.	Professional earnings		X

This categorization of the right to tax income is emblematic of the economic relationships of the time. It essentially rests on the foundational belief that parent companies (*ImperialCo* in *Mercantilist Paradigm Example* in Section II) provided the knowledge and capital to conduct operations in foreign countries by local subsidiaries (*IndiaCo*). The right to tax income from operations occurring in the Source (or colony) Country was allocated to the source country (the “origin country” in the Table) while taxation authority relating to other income was allocated to the place of residence of the parent company (“domicile country” in the Table). This categorization was not based on any analysis of the relative economic contributions of the various business activities to the actual profits earned by the respective companies.

In the *Mercantilist Paradigm Example* in Section II, the classification-and-assignment approach would result in *IndiaCo* having the right to tax profits attributable to

<sup>78</sup> *Id.* at 39.

<sup>79</sup> “Origin” should be read as source country.

<sup>80</sup> “Domicile” should be read as residence country.

the production of cotton or its conversion into commercial products. To the extent that profits were earned from the use of capital (corporate bonds), know-how (professional earnings), sale of goods in other countries, or dividends (corporate shares or public securities), the right to tax such items resided in the domiciliary or residence country (*ImperialCo*).

The 1923 Economic Experts Report recognized that the classification-and-assignment approach might misallocate income in a particular case, but the economic experts took comfort in the view that it was unclear at the outset which country would be a net beneficiary from an overly generous allocation of taxing jurisdiction.<sup>81</sup> Furthermore, even if overly generous, the 1923 Economic Experts Report advocated that Option 2's maximum allocation to the country of residence with respect to treaties entered into between developed countries that are on "equal footing" would represent a desirable outcome.<sup>82</sup> The report commented in passing that the classification-and-assignment approach might provide taxpayers with a de facto tax election due to their ability to create intermediate holding companies in tax-favorable resident jurisdictions, but this did not cause the committee to abandon the approach.<sup>83</sup> Thus, the categorization methodology set forth in the report failed to address the potential that the economic world could be composed of not only "origin" or "domicile" countries but also third countries that made no economic contribution to the production of income. Accordingly, if *ImperialCo* in the *Mercantilist Paradigm Example* had established an international subsidiary in a third country that had no or minimal income tax, in essence, it would be viewed as a residence country.

Seligman later explained that the objective in the 1923 Economic Experts Report was that "all intangible wealth, except real estate mortgages, should be assigned predominately or wholly, to domicile."<sup>84</sup> Routine business profits could also be transferred away from source country taxation if they were earned in a manner that did not create a permanent establishment ("PE") in the source country or were not attributable to immovable property.<sup>85</sup> The 1923 Economic Experts Report disparaged source-based tax regimes as involving antiquated theories of taxation and predicted that source-based taxation would diminish in importance as semi-developed nations became more industrialized and as modern notions of the pure income tax became more widely understood and appreciated.<sup>86</sup> These comments are insightful because they underscore that these economic experts of the time were attempting to introduce a grand experiment designed to transform the world. The organizing principle of these experts and of residence countries formulating the policies of the League of Nations was clear: base erode colony countries for the benefit of imperial countries (themselves), the originators of capital and know-how (the "foundational premise").<sup>87</sup>

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<sup>81</sup> *Id.* at 45–46.

<sup>82</sup> *Id.* at 48.

<sup>83</sup> *Id.* at 49.

<sup>84</sup> SELIGMAN, *supra* note 64, at 127.

<sup>85</sup> As will be developed below, the term PE refers to, in essence, taxable presence in the source country.

<sup>86</sup> 1923 *Economic Experts Report*, *supra* note 67, at 51.

<sup>87</sup> The elements of the foundational premise, as it evolved, in subsequent years, are noted at Part VI, *infra*.

Another important element was that Great Britain in the 1920's was a significant net capital exporter<sup>88</sup> and attempted to tax resident corporations on a worldwide basis, and so it was in its national interest to promote a solution to international double taxation that allocated taxing jurisdiction over residual income to the residence country and away from the country of source.

Before addressing the evolution of the classification-and-assignment approach over time, it is helpful to note that the League 1923 Economic Experts Report could have instead recommended that residual income of a global company be apportioned between the residence and source countries based on the relative economic contributions conducted in each country (the ICC model approach). The report, however, rejected out of hand the idea of so apportioning residual income because "the methodology has no fundamental basis in economic theory which is capable of easy application."<sup>89</sup>

These statements disregarded experience. Profit-split or formulary apportionment methodologies were commonly employed in tax treaties at the time.<sup>90</sup> The ICC had pressed the League to adopt principles consistent with those of the ICC draft 1923 resolutions that endorsed a formulary apportionment approach.<sup>91</sup> Yet, the League 1923 Economic Experts Report contained no serious discussions of these treaties or of the formulary apportionment approach advocated in the ICC's draft 1923 resolutions. The rejection of a profit-split approach by the League 1923 Economic Experts Report was controversial.

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<sup>88</sup> SELIGMAN, *supra* note 68, at 138 (pointing out that this bias is particularly helpful to creditor countries like England). The United States was in a similar posture. In fact, one U.S. government official testified that at this time the United States exported approximately four times as much capital as it imported. See H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT'L L. 359, 366 (1981).

<sup>89</sup> 1923 *Economic Experts Report*, *supra* note 67, at 46. The report recognized that the British Imperial Government actually utilized this approach, but ascribed its success to "the use of a common language, the existence of a common conception of income so that divergences are of the smallest character, the easy relations that exist of a political character to enable the necessary data to be determined—all these factors would put the easy working of [a profit-split or two-sided TP methodology] at a maximum in the case of the British Empire. It is not to be expected that a similar ease in working could be found as between countries with diverse language, diverse income-tax systems, diverse conceptions of income and less effective political connections." *Id.* at 47. This view of formulary apportionment-type TP methodologies continues to this day in the OECD TP Guidelines. See generally OECD TRANSFER PRICING, *supra* note 6, at ¶¶ 1.21, 4.06[3]. Nonetheless, formulary apportionment-type methodologies are in common use in the tax world. They are commonly used in U.S. state taxation models, as discussed in Part XII.E.2, *infra*. They are also on the table for broad utilization in the proposed European Union consolidated corporate income tax base, which would aggregate an MNE's combined income for EU purposes and then apply formulary apportionment principles to allocate the combined income. In this manner, all pertinent functions would be taken into account for income allocation (TP) purposes.

<sup>90</sup> Mitchell B. Carroll, *A Brief Survey of Methods of Allocating Taxable Income Throughout the World*, in LECTURES ON TAXATION 131, 151–53 & 168–70 (Roswell Magill ed., 1932) (stating that fractional apportionment was the primary method of resolving double taxation for Spain and Switzerland and was also used by France; also providing an analysis of how Austria, Czechoslovakia, Hungary, and Poland had all formulated significant profit-split methodologies); see also HERNDON, note 65, at 15 (describing a pre-existing Germany-Holland treaty where income apportionment was used for a railroad between the two countries); SELIGMAN, *supra* note 68, at 138 (recognizing that Great Britain had employed formulary apportionment methods with respect to its colonies but still maintained that this method was not practical). As indicated below, there is today extensive experience in addressing such issues, principally involving the use of two-sided TP methodology in bilateral advance pricing agreement (APA) or double taxation cases (where one country asserts a claim to a higher share of residual profits and the dispute is resolved through a competent authority treaty resolution process).

<sup>91</sup> See 1923 *ICC Proceedings*, *supra* note 33, brochure 25, n. 29, at 10–12. Indeed, the ICC referred to the principles espoused by Seligman, one of the League's economists. *Id.*

In 1925, the technical experts issued their first report to the League of Nations.<sup>92</sup> It stated that the residence country<sup>93</sup> should be given primary jurisdiction over income but that the source country should have a right to tax income from real property, agriculture, and income from commercial and industrial undertakings.<sup>94</sup> Furthermore, the League 1925 Technical Experts Report recognized that numerous examples existed of efforts to utilize Option 3's profit-split or formulary apportionment approach, including by Great Britain with its colonies, by Swiss cantons among themselves, and by several countries in Central Europe in numerous treaties.<sup>95</sup> In fact, the report at one point stated that the method of apportioning profits "appeared at first sight to be the one which was most generally in use."<sup>96</sup>

Notwithstanding the numerous examples of profit-split methodologies and recognition of the risk of artificial allocations of income under a preset classification-and-assignment approach, the League 1925 Technical Experts Report summarily rejected the idea of analyzing the possibility of adopting a profit-split methodology, stating that "we do not think that it would be possible to adopt generally such a very complicated [profit-split methodology] system in the international sphere."<sup>97</sup> This comment was certainly not true at the time because the members of this committee had ample evidence to use to develop profit-split models that would fairly and accurately allocate income between the source and residence countries. By suggesting that a profit-split apportionment approach was too hard, the committee was able to side-step further rigorous inquiry about whether this result could avoid the misallocation issues that the classification-and-assignment approach could create. In any event, the League 1925 Technical Experts Report recommended that work should begin on developing a model income tax treaty along the lines it advocated.<sup>98</sup>

## V. COORDINATION OF THE LEAGUE AND THE ICC POSITIONS

The ICC Committee on Double Taxation, chaired by Thomas Sewall Adams, met in May 1925.<sup>99</sup> The U.S. delegation included the Chairman of the House Committee on Ways & Means (William R. Green).<sup>100</sup> The ICC Committee on Double Taxation accepted the preference for a residence basis of taxation, with the source country right to

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<sup>92</sup> W.H. Coates, *Double Taxation and Tax Evasion: Report and Resolutions Submitted By the Technical Experts to the Financial Committee of the League of Nations*, League of Nations Doc. C.115M.55.1925.II.A (1925) (hereinafter *1925 Technical Experts Report*).

<sup>93</sup> *Id.* at 21 (stating that place of residency for a joint stock company meant its place of fiscal domicile, which would be determined as the place where "management and control of the business are situated").

<sup>94</sup> *Id.* at 31.

<sup>95</sup> *Id.* at 12–14; see also the 1921 Austro–Hungary Treaty, discussed *supra* note 56; Mitchell B. Carroll, *Methods of Allocating Taxable Income, Taxation of Foreign and National Enterprises Vol. IV*, League of Nations Doc. C.425(b) M.217(b) 1933 II.A. at 57–87 (1933); and the discussion of pre-existing income apportionment schemes *supra* note 90. As will be indicated below, there is today extensive experience in addressing such issues, principally involving the use of two-sided TP methodology in bilateral advance pricing agreement ("APA") or double taxation cases (where one country asserts a claim to higher share of residual profits and the dispute is resolved through a competent authority treaty resolution process).

<sup>96</sup> *1925 Technical Experts Report, supra* note 92, at 14.

<sup>97</sup> *Id.*

<sup>98</sup> *1925 Technical Experts Report, supra* note 92, at 29.

<sup>99</sup> *Id.* at 10–11.

<sup>100</sup> *Id.* at 11.

tax being strictly limited and not entitled to, in essence, impose a profit-split approach on the combined income of the foreign company.<sup>101</sup>

The Third ICC Congress met in Brussels in June 1925,<sup>102</sup> five months after the League 1925 Technical Experts Report was published. A delegate from the Financial Committee of the League of Nations also attended.<sup>103</sup> The proceedings noted that the League Committee of Technical Experts, following the work of the League's 1923 Economic Experts Report, had contacted the ICC with respect to the views of taxpayers (business).<sup>104</sup> The ICC group met with the League Committee of Technical Experts in Geneva in April 1924 to present its views on double taxation. Cooperation between the ICC and the League was recited in the proceedings of both.<sup>105</sup>

The League 1925 Technical Experts Report, issued five months earlier, appears to have overstated the preference of the ICC, as least as of the Second ICC Congress in 1923, for residence-based taxation. It may be that this reflected the interim discussions, recited by the ICC, in which the ICC Committee on Double Taxation deferred to the League's technical experts. This view is supported by the following statement by T.S. Adams who described the "working agreement" between business (the ICC) and governments (the League) in the following manner:

The working plan for the general elimination of double taxation . . . is based upon the frank recognition of the fact that the income-tax serves two purposes: it must satisfy the claim both of the country or origin and of the country in which the taxpayer resides; part of the income will inevitably be taxed where it is earned and part where the taxpayer resides. This is the first time perhaps that full recognition has been given to the valid claims of the country of origin and the country of residence.

The Committee of the International Chamber very clearly records its conviction that double taxation is particularly pernicious, because the burden is likely to be borne by the borrowing taxpayer or country. It is essential that the interest of the debtor countries and business enterprises obliged to borrow [from the creditor countries and business enterprises, presumed to be at the place of residence], that double taxation should be obviated wherever possible.

. . . .

With respect to firms doing business in foreign countries, the Committee recommends that agencies not an integral part of the enterprises, established on the basis of commission only, should be exempt from taxation in the country where the agency is established, except in so far as the profits of the agent himself are concerned. Where the business enterprise maintains in a foreign country a genuine commercial or industrial establishment, the latter is to be taxed upon the profits derived

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<sup>101</sup> *Id.* at 7–8. Italy reserved on the preference for residence, as it had in the League of Nations proceedings. It proposed that different rules be applied for taxes *in rem* (on property) and *in personam* (everything else, including most cross-border business). See *1925 ICC Proceedings*, brochure 34, at 9 [hereinafter *ICC Brochure no. 34*].

<sup>102</sup> See generally *ICC Brochure no. 34*, *supra* note 101..

<sup>103</sup> *Id.* at 10.

<sup>104</sup> See *id.*

<sup>105</sup> See *id.*; see also reference to the work of the ICC in *1925 Technical Experts Report*, *supra* note 92. The discussions in Geneva are also discussed in *ICC Brochure no. 34*, *supra* note 101, at 34–35.



in the foreign country, but where an agency only is maintained, taxation is to be confined to the agent's commission.<sup>106</sup>

In short, the ICC eventually accepted that: (1) the primary right to tax profits from cross-border enterprise was in the residence country; (2) the source country could not seek information about profits earned by the enterprise outside the source country (that is, no profit split); and (3) in the case of what became a PE, the source country could tax only the income derived in its country. The rationale for these conclusions seemed to arise from the fact that source countries were presumed to be importers of capital, which would be the fuel to generate profits.<sup>107</sup>

## VI. LEAGUE OF NATIONS EVOLUTION

As noted, the League of Nations commissioned a broader group of technical experts that included the United States (represented by Adams<sup>108</sup> and assisted by Mitchell B. Carroll) to create a model income tax convention.<sup>109</sup> This group met in April 1927. The British technical expert, Sir Percy Thomas, continued to argue in favor of residence-based taxation as had the League 1923 Economic Experts Report and the League 1925 Technical Experts Report,<sup>110</sup> as also accepted by the ICC, but finally on the last day of the

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<sup>106</sup> *ICC Brochure no. 34, supra* note 101, at 15; *see also id.* at 14, 16–17. The text of the actual ICC resolutions is consistent with the explanations of T.S. Adams, *see id.* at 17–18, as are the resolutions of the League Technical Experts. *Id.* at 19–21. The only point of difference between the League of Nations and the ICC in the Geneva meetings concerned the taxation of a foreign enterprise having a “genuine commercial or industrial establishment” in another country. *Id.* at 18 (Resolution 4 of the ICC). The ICC position was that each country could tax only the portion of the income earned its territory. An illustration of this position was offered by the British representative (Sir Algernon Firth):

if a man had a commercial establishment (a factory, a shop, a bank) in a foreign country, that country might collect *impôts réels* on it. If he only had an agent or permanent representative, the foreign country had no rights upon the profits of the firm in that country. Fancy the position of a firm having agencies in 20 different countries if it had to present in 20 different fiscal authorities 20 balance sheets. Would it be possible for any firm to keep any process secret? The Committee admitted that it was unfair that an agent should work in a country and not be taxed there, but they recognized that it would be absolutely impossible for firms to produce the number of balance sheets that would be required if the suggestion of the Experts were adopted, and so it was hoped most strongly that the meeting would adopt the [ICC] Committee recommendation.

Resolution of the issue was, in essence, deferred to a subsequent League of Nations conference that would include a broader range of countries, including Germany, the South American countries, and, it was hoped, the United States. *See 1925 ICC Proceedings, supra* note 31, brochure 43, at 15, 22. These meetings appear to have been convened in 1927, anticipating resolution in 1928. *See International Chamber of Commerce, Resolutions Passed at the Stockholm Congress* (June 27–July 2, 1927), brochure 60, at 22.

<sup>107</sup> *See 1923 ICC Proceedings, supra* note 33, brochure 25, at 7–13.

<sup>108</sup> For an excellent work on the contributions made by Adams to U.S. income tax policy, *see Graetz & O’Hear, supra* note 30. (one of the few academic analyses of the formative work of the League of Nations, which was focused on the need for reform of the U.S. international tax regime as opposed to the need for reform of the global treaty models; there is an excellent discussion of the role of source in the formulation of U.S. policy, as well as the “essential dilemma” of residence vs. source).

<sup>109</sup> *See Graetz & O’Hear, supra* note 30, at 1081. *See also* Reuven S. Avi-Yonah, “All of a Piece Throughout: The Four Ages of US International Taxation,” 25 VA. TAX REV. 313 (2005) (seeming to suggest that Mr. Carroll was an important collaborator with Professor Adams); *see also* The Double Taxation Conference: London, April 5–12, 1927, Memorandum from Mitchell B. Carroll to T.S. Adams, at 19 (Sept. 26, 1927) (unpublished manuscript available in T.S. Adams Papers, Yale University, Box 13, Sept. 1926–1927 folder.)

<sup>110</sup> *See, e.g.,* League of Nations Comm. of Experts on Double Tax’n & Fiscal Evasion, Minutes of the Tenth Meeting held in London at 5 p.m. on Tuesday April 12th, 1927, D.T./8th Session/P.V. 10(1), at 6–7 (available at T.S. Adams Collection, Yale University, Box 16, League of Nations Apr. 12, 1927 folder.)

conference a compromise was reached along the lines urged by the newest member of the committee, Adams. He advocated that the source country should have the right to impose “impersonal taxes” (that is, withholding taxes) on the various classes of income while the country of residence should provide a foreign tax credit (“FTC”) for the withholding taxes paid to the source country.<sup>111</sup> Also, several experts championed a proposal endorsed by the ICC that a foreign enterprise should not be considered to have a PE in a source country simply because it transacts business in the source country through an independent agent,<sup>112</sup> and the committee adopted this recommendation.<sup>113</sup> The impact of this recommendation was to exempt from source country taxation all profits derived by a foreign enterprise through independent agents,<sup>114</sup> but, importantly, branches, affiliate companies, and dependent agents still constituted a PE under the draft convention.<sup>115</sup> Furthermore, the Fiscal Committee made it clear that a source country would have no right to tax business profits from industrial and commercial activities on a net basis unless the foreign parent had a PE in the country.<sup>116</sup>

After making these important clarifications, the Fiscal Committee issued their report on April 15, 1927, and accompanying their report was a draft model income tax treaty (the “1927 Draft Model Convention”) that utilized the classification-and-assignment approach set forth in the League 1923 Economic Experts Report and the League 1925 Technical Experts Report but with the more narrow PE definition.<sup>117</sup>

In October, 1928, the League of Nations’ technical experts met again and issued a final report.<sup>118</sup> Importantly, each of the potential models continued the classification-and-assignment approach that had by then been repeatedly endorsed.

The 1928 Model Conventions became the benchmark for treaty negotiations in Europe, and these model conventions were instrumental in the development of the earliest U.S. tax treaties.<sup>119</sup> Thus, the classification-and-assignment approach utilized in the 1928 Model Convention transformed treaty negotiations. Once this treaty framework was in place, the balance of power between source and residence countries was significantly changed through a continuing redefinition of the scope of activities that would fall within the purview of a PE and through continuing efforts to minimize the amount of source-based withholding taxes that would apply to cross-border payments.

The order of tax treaty principles that were so formulated could be distilled into five principles:

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<sup>111</sup> See *Report Presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.216M.85.II.A, at 11 (1927) [hereinafter *1927 Technical Experts Report*]; see also Memorandum from Mitchell B. Carroll to T.S. Adams, *supra* note 109, at 19.

<sup>112</sup> See League of Nations Comm. on Double Taxation and Fiscal Evasion, Minutes of the Third Meeting held at London on April 6th, 1927 at 3:30 p.m., League of Nations, DT/8th Session, P.V.3.(1), at 9-10 (proposal made by M. Julliard representing the ICC and endorsed by Adams) (available in T.S. Adams Collection, Yale University, Box 16, League of Nations Apr. 4-6, 1927 folder.)

<sup>113</sup> See League of Nations Comm. on Double Tax’n & Tax Evasion, Minutes of the Fourth Meeting held in London on April 7th, 1927 at 3:30 p.m., League of Nations, D.T./8th Session/P.V.4.(1), at 2 (proposed change to permanent establishment definition adopted) (available in T.S. Adams Collection, Yale University, Box 16, League of Nations Apr. 7 & 8, 1927 folder.)

<sup>114</sup> See Memorandum from Mitchell B. Carroll to T.S. Adams, *supra* note 109, at 6.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *1927 Technical Experts Report*, *supra* note 111, at 10-11.

<sup>118</sup> *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562M.178 1928 II (1928) [hereinafter *League 1928 Report*]. See generally Graetz & O’Hear, *supra* note 30, at 1023-24.

<sup>119</sup> See Rosenbloom & Langbein, *supra* note 88, at 365.

1. Source country should tax local operations, including property or other pertinent matters.
2. Residual income should be earned by the country of residence, which provides the knowledge, capital, and global markets for the business.
3. Presence of an interim holding company should be treated as a residence Country.
4. Subsidiaries should not be treated as a PE<sup>120</sup>).
5. TP is to be evaluated on a separate account basis (i.e., one-sided TP principles).

The model treaties that eventually became the OECD Model, and subsequently the UN Model, are based on these five principles, which comprise the elements of the foundational premise.

Not surprisingly, the effective tax rate strategies of MNEs evolved based on this treaty model, as contemplated in the work of the League of Nations.

#### VII. THE HUNGARY PROBLEM

On May 12, 1928, Poland and Hungary executed a tax treaty that used the framework of the 1927 Draft Model Convention. The Hungary-Poland tax treaty is notable in that it turned the intended result of that convention on its head by tweaking its terms to give a preference to source-based taxation.<sup>121</sup> To achieve this result the treaty provided that income from investments, savings accounts, and securities and all other “floating capital” would be taxed by the country in which the debtor was located (residence country).<sup>122</sup> Business profits would be apportioned between the countries where a business entity had an establishment, and for this purpose the term “establishment” was defined to include subsidiary corporations that operated in the source country just as the 1927 Draft Model Convention had done.<sup>123</sup> Furthermore, just like the 1927 Draft Model Convention, the term PE included all permanent representatives of the business entity whether or not the representative had the authority to bind the foreign company.<sup>124</sup> The Hungary-Poland tax treaty went on to provide that the combined income of the nonresident company and its subsidiaries would be apportioned between the two countries based on the relative gross income derived from the various establishments,<sup>125</sup> and the combined income would be determined using the general statement of accounts maintained by the business entities.<sup>126</sup> Furthermore, if these accounts were not reliable, then the two countries would consult one another to determine a fair allocation of the income.<sup>127</sup> This approach was, in essence, the 1923 ICC model.

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<sup>120</sup> See discussion in Section VII *infra*.

<sup>121</sup> Conventions between the Kingdom of Hungary and the Republic of Poland for the Prevention of Double Taxation in the Matter of Direct Taxation, May 12, 1928, 123 L.N.T.S. 47; for another contemporaneous attempt to achieve taxation that did not utilize the League of Nations’ model treaty, see Agreement between Spain and Italy Regulating the Fiscal Treatment of Companies, arts. 4, 5, Nov. 18, 1927, 82 L.N.T.S. 27.

<sup>122</sup> Hungary-Poland Treaty, *supra* note 121, at art. 5.

<sup>123</sup> *Id.* art. 3.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

The broad definition of PE to encompass the business operations of related corporations, the use of the global revenues of the overall related entities, and the use of a profit split based on gross revenues allowed Hungary and Poland to effectively achieve the Option 3 profit-split result that had been formulated (and rejected) in the 1923 Economic Experts Report. All of this was achieved within the framework of the League of Nations' own 1927 Draft Model Convention.

In a report dated October 26, 1929, the Fiscal Committee of the League of Nations noted that the Hungary-Poland convention had utilized the League of Nations' model convention to promote a source-based taxation result.<sup>128</sup> As a result, the Fiscal Committee concluded that the member nations needed a further explanation on how profits from industrial activities should be taxed.<sup>129</sup>

The next year, in a report issued in May 1930, the Fiscal Committee of the League of Nations definitively adopted its narrower PE definition that excluded independent agents.<sup>130</sup> The Fiscal Committee then recommended that royalties on patents, copyrights, and other types of intangible property associated with a commercial and industrial undertaking unrelated to real property should be taxed only at the fiscal domicile (residence) of the recipient if the owner of the intangible property did not otherwise have a PE in the source country.<sup>131</sup> It then established a subcommittee to determine whether the following further clarifying statement should be added to the PE definition:

The fact that an undertaking has business dealings with a foreign country through local company, the stock of which it owns in whole or in part, should *not* be held to mean that the undertaking in question has a permanent establishment in that country.<sup>132</sup>

Thereafter, the Fiscal Committee issued a report that set forth a revised draft model convention, which explicitly provided that a PE "does not include a subsidiary company."<sup>133</sup> The treaty also maintained an exemption for withholding taxes on

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<sup>128</sup> Fiscal Comm., *Report Presented to the Council on the Work of the First Session of the Comm.*, League of Nations Doc. C.516M.175.1929.II (1929), at 2.

<sup>129</sup> *Id.* at 2–3.

<sup>130</sup> Fiscal Comm., *Report to the Council on the Work of the Second Session of the Comm.*, League of Nations Doc. C.340M.140.1930.II.A (1930), at 4..

<sup>131</sup> *Id.* at 5–6; Fiscal Comm., *Report to the Council on the Work of the Third Session on the Comm.*, League of Nations Doc. C.415M.171.1931.II.A. (1931) (adopting the proposed principles).

<sup>132</sup> Fiscal Comm., *1930 Report*, note 124, at 9 (emphasis added). Blau, the representative of Switzerland, requested that this provision should be considered because the ICC had adopted a resolution earlier in 1929 to the same effect. See *Minutes of the Second Meeting of the Committee of Experts on Double Taxation and Fiscal Evasion* at 4:00 p.m. on Thursday, October 17th, 1929, F/Fiscal 1st Session/P.V.2.(1) League of Nations, at 3. The next year, some members pressed for adoption of this clarifying statement without further study, but this proposal was rejected. See *Minutes of the Sixth Meeting of the Comm. of Experts on Double Taxation and Fiscal Evasion* at 3:30 p.m. on Wednesday, May 28th, 1930, F/Fiscal/2nd Session/P.V.6.(1) League of Nations, at 7. Instead, the subcommittee that was established to address the allocation of profits would also consider the redefinition of a PE to exclude "affiliated companies." See *Minutes of the Seventh Meeting of the Comm. of Experts on Double Taxation and Fiscal Evasion* at 9:30 a.m. on Thursday, May 29th, 1930, F/Fiscal 2nd Session/P.V.7.(1), League of Nations, at 30–33 (Proposal 4 adopted with Flores de Lumus's amendment).

<sup>133</sup> Fiscal Comm., *Report to the Council on the Fourth Session of the Committee*, League of Nations Doc. C.399.M.204.1933.II.A. (1933), at 6 [hereinafter *League 1933 Report*]. Prior to this meeting, Adams, a defender of source-based taxation, died unexpectedly on February 8, 1933. The United States asked Carroll to replace Adams as the U.S. representative to the Fiscal Committee. MITCHELL B. CARROLL, GLOBAL PERSPECTIVES OF AN INTERNATIONAL TAX LAWYER 71 (1978). Shortly after this meeting, on November 6, 1933, Dorn withdrew from the Fiscal Committee as a result of Germany's decision to withdraw from the League of Nations entirely. See Fiscal Comm., *Resignation of Professor Dorn, Member of the Committee*,

royalties.<sup>134</sup> Furthermore, the report then attacked the Hungary treaty's global, multi-company allocation approach by setting forth an explicit framework for how business profits of a PE should be calculated:

The fundamental principle laid down is that, for tax purposes, permanent establishments must be treated in the same manner as independent enterprises operating under the same or similar conditions, with the corollary that the taxable income of such establishments is to be assessed *on the basis of their separate accounts*.<sup>135</sup>

The method of relying on separate accounts was defined by Carroll in his report submitted to the Fiscal Committee in the following manner:

The method of separate accounting means taking the declaration of income, supported by the accounts of the local branch, as a basis of assessment. This may entail a verification of the accounts and enquiry into the relations between the local branch and other establishments (branches or subsidiaries) of the parent enterprise, which involve, for example, consideration of the price at which goods have been invoiced to the branch and their original cost, and the amounts charged to the branch for services or representing a portion of general overhead expenses.<sup>136</sup>

Carroll went on to state that the method of separate accounts was the method normally followed "in the country which has the largest experience in the taxation of income," namely the United Kingdom, and characterized it as being the method used by countries that have "accountants of the highest professional standing."<sup>137</sup>

In its official report, the Fiscal Committee clarified that the arm's length standard would be determined by assuming that the PE were a separate entity, thus rejecting the global allocation approach articulated in the Hungary-Poland Treaty.<sup>138</sup>

In a report issued in June 1935, the Fiscal Committee endorsed the draft model income tax convention that had been submitted in 1933.<sup>139</sup> The 1935 Revised Draft Model Treaty "fixed" the PE definition by excluding the mere ownership of subsidiaries and limiting the business profits allocable to a PE to only the profits in the company's separate accounts.<sup>140</sup>

The consequence of removing subsidiaries from the definition of a PE, determining business profits allocable to the subsidiary in terms of a stand-alone (or one-sided TP) inquiry, essentially ignoring interim holding companies, and exempting royalties from source-based withholding taxation was to create significant tax planning opportunities. By utilizing the investment structure set forth in *Mercantilist Paradigm Example*, a significant opportunity existed to base erode the colony country, which was

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League of Nations Doc. C.677.1933.II.A. (1933). The departure of Adams and Dorn, both of whom showed some balance in terms of source-based taxation, occurred mid-stream during the transitional period when the League of Nations was moving away from its 1928 Model Convention and towards the 1935 Revised Draft Model Treaty.

<sup>134</sup> *League 1933 Report*, *supra* note 133, at 3–4.

<sup>135</sup> *Id.* at 2 (emphasis added).

<sup>136</sup> MITCHELL B. CARROLL, LEAGUE OF NATIONS FISCAL COMM., TAXATION OF FOREIGN AND NATIONAL ENTERPRISES 45 (1933)

<sup>137</sup> *Id.* at 47.

<sup>138</sup> *See League 1933 Report*, *supra* note 133, at 2.

<sup>139</sup> Fiscal Comm., *Report to the Council on the Fifth Session of the Committee*, League of Nations Doc. C.252M.124.1935.II.A. (1935), at 3, 5–7.

<sup>140</sup> *Id.* at 5–6.

the desired objective of the framers (principally imperial countries) of the foundational premise.<sup>141</sup>

Carroll would later say that “the advocates of the method of separate accounting as the basic method for allocating taxable income have won a decided victory in the international sphere over the supporters of fractional apportionment” and that fractional apportionment “had been relegated to the place of a last-resort measure in the international sphere.”<sup>142</sup> In applying the arm’s length method, Carroll consistently employed transactional methods or one-sided TP methods, as he considered a profit split (a two-sided TP method) as a “rarely used” method that would only be utilized if no other transactional comparable could be found.<sup>143</sup>

The international paradigm that framed subsequent discussions between developed and developing nations would contain the elements of the foundational premise.<sup>144</sup> In concert, these elements of the 1935 Revised Draft Model Treaty shifted the balance of power away from source countries and toward the country of residence. Member nations were dutifully conforming.<sup>145</sup>

The net result of the 1935 Revised Draft Model Treaty was that the bilateral principles had been established for the legitimacy of residence-based taxation. In the process of developing TP policies to remove residual income from source countries and allocating it to the residence country (including interim holding companies in third countries treated as a residence country) MNEs were implementing the policies specifically approved and prescribed by the League of Nations. Indeed, if they were to have done otherwise, application of the mutual agreement provisions of the model treaties would have enforced such policy orientation.

#### VIII. HOMELESS INCOME: THE NAGGING REALITY CHECK

While the residence-based paradigm may have been established, there was a problem. The model encouraged MNEs to remove earnings from “floatable capital” out of the source country and create homeless income. The purpose behind the 1928 Model Tax Treaty was to avoid double taxation, not to create non-taxation. Yet, the creation of homeless income is exactly what occurred as a result of the five elements noted above.<sup>146</sup> A “no taxation result” was viewed as a mistake, a fiscal fraud.<sup>147</sup> Of course, this was a rather contradictory conclusion to the process that facilitated the creation of homeless

<sup>141</sup> See *infra* Parts IV and VI.

<sup>142</sup> Carroll, *supra* note 23, at 473, 473 n.4. The role of Carroll should not be underestimated. He drafted Model 1-b of the 1928 Model Tax Treaty for Adams. CARROLL, *supra* note 133, at 32. Carroll’s study of attribution of profits was very significant in framing acceptance of the arm’s length standard by the League of Nations. See *id.* at 70–71. He was the President of the Fiscal Committee of the League of Nations from 1938 to 1946. *Id.* at 71. He was the first President of the International Fiscal Association. *Id.* at 32. Carroll was present in the drafting of the 1963 OECD Model Convention. He was also present in the meetings with Stanley Surrey to develop the U.N. model treaty. U.N. Dep’t of Econ. & Soc. Affairs, Tax Treaties Between Developed and Developing Countries: Second Report, at 26, U.N. Doc. ST/ECA/137, U.N. Sales No. E.71.XVI.2 (1970) [hereinafter 1970 U.N. Second Report]. Carroll was also involved in the actual drafting of the eventual U.N. model treaty. See U.N. Dep’t of Int’l Econ. & Soc. Affairs, Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, at 7, U.N. Doc. ST/ESA/94, U.N. Sales No. E.79.XVI.3 (1979) [hereinafter 1979 U.N. Manual].

<sup>143</sup> See Carroll, *supra* note 23, at 483, 485–86.

<sup>144</sup> See *infra* Section IV.

<sup>145</sup> See Fiscal Comm., *supra* note 139, at 3-4 (stating that “existence of model treaties of this kind has proved of real use” and showing the number of treaties that are now conforming to the model treaty).

<sup>146</sup> See *supra* Part VI.

<sup>147</sup> Fiscal Comm., *Report to the Council on the Sixth Session of the Committee*, League of Nations Doc. C.450M.266 1936 II.A. (1936), at 1.

income, as noted above. In response to the then growing problem, on October 9, 1936, the Assembly of the League of Nations adopted the following stinging resolution:

The Assembly,

Considering that efforts to reduce the obstacle to the international circulation of capital *must not have the effect of increasing fiscal fraud*;

. . . .

*Requests the Fiscal Committee to pursue vigorously its work for the avoidance of double taxation as far as possible, and also its work on the subject of international fiscal assistance, in order to promote practical arrangements calculated, as far as possible, to put down fiscal fraud.*<sup>148</sup>

Thus, soon after the Fiscal Committee had dismantled the source-country tools to levy taxes on residual income related to movable capital (i.e., the foundational premise),<sup>149</sup> the Fiscal Committee found itself being questioned by the Assembly about whether it had done enough to ensure that fiscal fraud (that is, homeless income) was being addressed with sufficient vigor.

The Fiscal Committee agreed that tax evasion was achieved through income from movable capital. It was then faced with a choice. It could recognize that the taxpayer's right to choose the country of residence represented a de facto tax election which, when coupled with the elimination of source country taxation, allowed the taxpayer to create homeless income. Alternatively, it could double-down on its deference to residence-based taxation. The Fiscal Committee refused to alter its mindset, and instead proposed that each country should adopt domestic rules to address the problem of movable income. The response was a clear lack of interest in a country developing an infrastructure to track movable capital for a third country when there was no financial benefit that would inure to that country.<sup>150</sup>

Recognizing that there was "insuperable opposition" to this solution, the Fiscal Committee suggested that a second-best solution would be to adopt exchange-of-information agreements as part of the tax treaty network, though it held out little hope that this was a comprehensive solution.<sup>151</sup>

Thus, the Fiscal Committee admitted that its only solution to the homeless income problem was unworkable. Nonetheless, it remained unwilling to change its policy of promoting residence-based taxation over source-based taxation.<sup>152</sup>

This ultimately led to the evolution of outbound (such as controlled foreign corporation ("CFC"), FTC, and related regimes) and inbound (such as earnings-stripping, thin capitalization, anti-avoidance, and related regimes) domestic legislation, often not subject to resolution in treaty-based dispute resolution procedures.<sup>153</sup>

<sup>148</sup> *Id.* at 1 (emphasis added).

<sup>149</sup> *See supra* Part IV.

<sup>150</sup> *Id.* at 2.

<sup>151</sup> *Report Presented by the Fiscal Committee to the Council During Its Seventh Session of the Committee*, League of Nations Doc. C.490 M.331 1937 II.A. (October 16, 1937), at 2.

<sup>152</sup> The U.N. Ad Hoc Group of Experts would later comment that this discussion of international tax evasion was the last in-depth discussion of tax evasion and avoidance in international forums until the 1970s. *See* U.N. Dep't of Int'l Econ. & Soc. Affairs, *Tax Treaties Between Developed and Developing Countries: Eighth Report*, at 7–8, U.N. Doc. ST/ESA/101, U.N. Sales No. E.80.XVI.1 (1980) [hereinafter 1980 U.N. Eighth Report].

<sup>153</sup> The relationship of these outbound and inbound regimes to tax base defense in the 21st century is discussed at Wells & Lowell, *Homeless Income and Tax Base Erosion*, *supra* note 10, at 584–94.

## IX. COMPOUNDING THE MISTAKE OF HOMELESS INCOME

Interestingly, the ICC, after being silent on the subject of double taxation since 1925, addressed the subject of homeless income in 1951.<sup>154</sup> It noted that a country should draw its tax frontier vis-à-vis foreigners so as to exempt from domestic taxation a broad range of essentially base-stripping mechanisms. In addition, a country should also not inquire “into the total income of the non-residents.”<sup>155</sup> In recognition of the flaw in the foundational premise of residence-based taxation caused by intermediary companies (i.e., homeless income), the ICC proposed that “intermediary countries” should be treated as the residence country and should not tax subsequent distributions of income.<sup>156</sup>

This proposal was submitted to the Fiscal Commission of the then new United Nations.<sup>157</sup> In essence, the ICC proposed that an intermediary country, even if it had no or a low effective tax rate, should be treated as the residence country. This emboldened effort to obtain explicit protection for a low-taxed intermediate holding company structure demonstrates that homeless income tax planning had by this time become well understood and of significant importance to the business community.

In any event, the ICC 1951 proposal had been an element of the foundational premise from inception, but in 1951 it was clearly and explicitly framed.

## X. POLICY EVOLUTION IN THE 1951 – 2012 PERIOD

In the period since 1951, global tax treaty policy has stood still. There have been domestic tax base defense efforts in the form of ever-tightening CFC, FTC, earning-stripping, and related outbound and inbound regimes, as well as a global effort to police the perceived base-stripping activities of MNEs via the introduction of broad-based TP documentation, examination, and penalty regimes.<sup>158</sup> The near universal questioning of the extant model tax treaty policy was germinated by the tensions noted at the beginning of this article.<sup>159</sup>

In this regard, it is also worth noting, though beyond the scope of this article, that many former residence countries, including most OECD member countries, are increasingly adopting policies designed to attract economic activity to their own borders and abandoning efforts to impose domestic taxation of an extra-territorial basis (such as the outbound and inbound regimes noted above). This is plainly evident in the current international taxation proposals in the United States of the Obama administration as well as proposals being considered on a bi-partisan basis in Congress, which include conversion of the current global taxation model to a “territorial” model, utilization of a “patent-box” regime to provide lower domestic taxation for creation, in essence, of jobs related to intellectual property.<sup>160</sup> Indeed, one of the most pervasive U.S. tax regimes of

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<sup>154</sup> See *Unilateral Relief from Double Taxation*, ICC Statement and Report of the Comm'n on Taxation 1951 [hereinafter *1951 Unilateral Report*].

<sup>155</sup> *Id.* at 2.

<sup>156</sup> See *1951 Unilateral Report*, *supra* note 154, at 10–11.

<sup>157</sup> See *1951 Unilateral Report*, *supra* note 154, at 11.

<sup>158</sup> See OECD TRANSFER PRICING, *supra* note 6, at ch. 14 (listing the requirements of 70+ countries).

<sup>159</sup> See *supra* Part I.

<sup>160</sup> See LOWELL ET. AL, U.S. INTERNATIONAL TRANSFER PRICING, *supra* note 2, at ¶ 2.02[22].



recent vintage is the so-called FATCA imposition of withholding taxes on U.S. source investment income.<sup>161</sup>

These evolutions stand as mute testimony to the reality that the world has changed since the 1920s. The former source-colony countries have in many cases become residence-imperial countries, as many creditor countries of that era have become debtor countries. In the *Mercantilist Paradigm* noted above,<sup>162</sup> a case could certainly be made that, in many respects, India has taken the place of England (as has China taken the place of the United States).

#### XI. FOUNDATIONAL PREMISE UNDER ORIGINAL ICC APPROACH

As noted above,<sup>163</sup> the foundational premise had several elements. These elements would have been entirely different under the original ICC approach as follows:

1. Source country should tax *functions actually performed in that country local operations*;
2. ~~Residual~~ combined income should be allocated between ~~earned~~ by the country of source and the country of residence by agreement of the countries or on the basis of a specified factor;
3. Presence of an interim holding company should be *ignored or treated as the source country and its treaty partner country determine* ~~treated as a residence country~~;
4. *Treatment of subsidiaries* ~~Susidiaries should not be treated as~~ permanent establishments *is no longer relevant*; and
5. TP is to be applied on a combined basis.

Needless to say, had the OECD and UN model treaties been developed based on these principles, the tension of today would be quite different.

#### XII. POLICY EVOLUTION IN THE FUTURE

As in the post-World War I period, there is today a global need for economic growth. Designing policies to generate growth is complex. Certainly, one important element is international tax policy. All members of the international taxation community have a common interest in finding a solution to the current tension that is appropriate to the economics and realities of the early twenty-first century, not trying to continually paper-over the policies of the early twentieth century.

In view of the history of the current OECD and UN model treaties, it is not surprising that there is tension between source countries, residence countries, the OECD, the UN, and MNEs with respect to international taxation. It is inevitable that, in due course, there will be systematic re-examination of global tax treaty policy. Hopefully, this will occur in a context where all countries, residence, source, or otherwise, can come together and craft an order of global taxation that fits the world as it is. The forum for these discussions will remain to be determined.

As the process evolves, we respectfully submit that there are several conceptual challenges that will need to be thoughtfully addressed, including the following:

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<sup>161</sup> See Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, 124 Stat. 71. See generally CYM LOWELL & MARK R. MARTIN, U.S. INTERNATIONAL TAXATION: PRACTICE & PROCEDURE ¶ 7.05[1][f] (2012).

<sup>162</sup> See *supra* Part II.

<sup>163</sup> See *supra* Parts II.A and VI.

### A Purpose of the Foundational Premise

The first conceptual challenge is to recognize that the existing model treaties, and the original TP rules to implement those treaties, were purposefully skewed. Prior to the work of the League of Nations, several treaties had engaged in profit-split or formulary apportionment methodologies.<sup>164</sup> This was in earlier times the dominant method of allocating income from cross-border activities. Homeless income should not survive in such a world and appears not to have existed under such methodologies. Rather, income was allocated to the country where the underlying economic activity occurred. PE concepts were not relevant, as they are largely a function of the foundational premise.

The victors of WWI wanted to reshape the world into their mercantilist mindset. Their solution was that residual income should belong to the country of residence, not to the country where the economic activity occurred. One-sided TP methods served their purpose because source countries would focus only on the in-country subsidiary as the “tested party” to be allocated a routine return. All residual income by default went to the residence country (the “untested party” to use consistent TP terminology) without principled examination of overall function, risk, or investment.<sup>165</sup>

It is important to recognize that this was a purposeful step that served the interest of the capital exporting nations which wanted to maximize the potential allocation of residual income to their own countries. The discussion in the original archives is amazingly frank.<sup>166</sup> In other words, the original “earning strippers” (when viewed from the standpoint of source countries of today) were the government officials of capital exporting nations circa 1920s. To a significant extent, the governments that now pillory MNEs for creating homeless income were the framers of the mercantilist approach to international taxation that created the opportunity in the first place.

Can the residence countries of yesteryear evolve to embrace a new model? The answer to this conceptual issue is clear. It is in the affirmative and has already occurred, as most of these countries have already embraced a territorial model, as will be noted below.<sup>167</sup>

### B. Source Country Emergence to Residence Country

Another conceptual challenge to serious re-engineering of our model treaties is the economic migration of many source (or colony) countries from the 1920s period, in which the foundational premise was born, to their current status as residence (capital exporting) countries. For example, India was the model colony country in the 1920s discussions.<sup>168</sup> Like the other BRICS and many source countries of today, it is a serious economic power intent upon defending its own tax base, just as were the original residence countries in the 1920s.

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<sup>164</sup> See *supra* Part VII.

<sup>165</sup> See Double Taxation, in International Chamber of Commerce, *Resolutions Passed at the Stockholm Congress* (June 27–July 2, 1927), brochure 60, ch. V, at 21. The terminology in the text is stated in current terms adapted from the words actually used in 1927.

<sup>166</sup> Mr. Carroll would later say that “the advocates of the method of separate accounting as the basic method for allocating taxable income have won a decided victory in the international sphere over the supporters of fractional apportionment” and that fractional apportionment “had been relegated to the place of a last-resort measure in the international sphere.” Carroll, *supra* note 23. See also discussion of the importance of Mitchell B. Carol, *supra* note 142.

<sup>167</sup> See *supra* Part XII.

<sup>168</sup> See *supra* Parts II and III.

This emergence is a transformative element of the treaty policy dialogue. Many of these countries are not OECD members. The challenge here is likely to be which countries will be the driving forces in determining the appropriate treaty policy for the future. Will it be the OECD, the UN, a new organization reflecting the interests of the BRICS and source countries, or a communal effort of all of parties?

C. Territorial Taxation: A Confusing Race to the Bottom

A third conceptual challenge is the trend toward territorial taxation.<sup>169</sup> In such a world, a residence country relinquishes its right, under the foundational premise, to assert taxation on residual income from economic activities that have no nexus to its jurisdiction other than stock ownership. This process, which results from countries competing with one another for MNE headquarters locations, amounts to an international race to the tax bottom.<sup>170</sup>

From a treaty policy standpoint, this is rather confusing. The residence countries of the post-World War I era demanded the foundational premise. As the economic world evolved, including the emergence of former source countries as residence countries, many of the authors of the foundational premise have abandoned its critical objective of taxing foreign source income.

Have these countries already abandoned the foundational premise?

D. Secret World Provides Guidance for the Way Forward?

In the real world of today, major TP controversies between treaty countries are inevitably resolved via the mutual agreement provisions of the model treaties.<sup>171</sup> The proceedings are commonly referred to as involving the competent authorities, referring to the tax officials of the respective countries who are competent (authorized) to resolve potential double taxation cases.

In our experience in handling such cases around the world, the inevitable result is reached by the respective countries undertaking two-sided TP analysis to determine the appropriate amount of income to be allocated to its own domestic companies (i.e., subjected to domestic taxation). The results of these proceedings are necessarily secret, in the sense that there is no publication of the results (which are confidential taxpayer information), except in the form of broad statistical reports which are meaningless as a practical matter.

On the other hand, those actually involved in the process (as private or public parties) understand that the essential concepts of the original ICC proposal reflect the means by which real cases are actually resolved. In other words, there may be lip service to the foundational premise, but it is not followed in inter-governmental negotiations.

In other words, competent authorities, unaided by unworkable policy paradigms, have been left to fend for themselves to develop administratively workable concepts to resolve complex cases. This process is actually efficient in most developed countries, though it is just beginning in the BRICS and many other source countries.

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<sup>169</sup> See LOWELL ET AL., U.S. INTERNATIONAL TRANSFER PRICING, *supra* note 2, at ¶ 2.02[22].

<sup>170</sup> See, e.g., Jacques Malherbe, Philippe Malherbe, Hank Verstraelen & Pascal Fues, *Business Operations in Belgium*, 953 TAX MGMT. PORTFOLIO (BNA) at V.G- (setting forth special tax incentives to attract MNE headquarter functions to Belgium); John Ryan, Robert O'Shea & Aidan Fahy, *Business Operations in the Republic of Ireland--Taxation*, 965 TAX MGMT. PORTFOLIO (BNA) at XI.C (providing overview of various holding company incentives, headquarter incentives, financing incentives, and intellectual property incentives for MNEs in Ireland).

<sup>171</sup> See Richard M. Hammer et al., OECD TRANSFER PRICING, *supra* note 6, at ¶¶ 12.03 and 12.05.

Can the competent authority model serve as a useful guide in developing treaty policy for the future?

#### E. Perceptions of Homeless Income

As noted earlier, there are today persistent drumbeats pillorying MNEs for their global effective tax rate planning policies. The essential question here is whether such criticism is appropriate. Whether one's answer is affirmative or negative is largely irrelevant from a global tax treaty policy standpoint. Why? Because the behaviors in question were specifically encouraged by the League of Nations model and enshrined in the current OECD and UN models. The result has been the growth of homeless income. Perhaps the most difficult conceptual challenge for treaty and international tax policy in the future will center around how to address homeless income.

In *Illustration C*,<sup>172</sup> we framed homeless income in terms of the allocation to HoldCo. We assumed that India and Holdingland had agreed that the allocation between the two countries should be 50:50, which allocated 450 to HoldCo. In the absence of such agreement, the ICC approach would have required an allocation of the combined income on a notional basis such as sales.

For purposes of discussion, assume that the 450 allocated to HoldCo is subject to a low rate of taxation in Holdingland. In this event, the treaty policy question will be how the homeless income should be addressed. The answer will likely depend on the perspective of the respondent.

##### 1. Resident Country Perspective

A residence country may perceive that any global income not subjected to taxation or covered by treaty should be fully subject to tax by it with appropriate foreign tax credit relief provided. There is significant scholarly support for this perspective.<sup>173</sup>

There are practical problems with this perspective. One is that residence countries have never treated their domestic MNEs in a consistent manner. Rather, there are material differences in the international taxation regimes of almost all residence countries. The result has been competitive advantage or disadvantage depending on where a MNE is incorporated.

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<sup>172</sup> See *supra* Part II.A.

<sup>173</sup> There are a number of variations on the proposal to simply tax all MNE income on a current basis without deferral. See Jasper L. Cummings, Jr., *Consolidating Foreign Affiliates*, 11 FLA. TAX REV. 143, 195–96 (2011); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 31 TAX NOTES INT'L 1177, 1207 (2003); Robert J. Peroni, J. Clifton Fleming Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of US Tax On Foreign Source Income*, 52 SMU L. REV. 455, 458 (1999); see, e.g., Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219, 224 (1997); Asim Bhansali, *Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401, 1422 (1996); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581 (1990); Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165 (1996); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 75 (1993); John McDonald, *Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 NW. J. INT'L L. & BUS. 248, 281 (1995); Peter Merrill & Carol Dunahoo, *'Runaway Plant' Legislation: Rhetoric and Reality*, 72 TAX NOTES 221, 221 (1996); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042, 1061 (1996); Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062, 1063 (1988); Lee A. Sheppard, *Last Corporate Taxpayer Out the Door, Please Turn Out the Lights*, 82 TAX NOTES 941, 944 (1999). But see, James R. Hines, *The Case Against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385, 401–02 (1999).

In addition, if a residence country attempts to tax homeless income, taxpayers have the ability to simply “elect out” of that particular country and incorporate in a more taxpayer-friendly jurisdiction.<sup>174</sup> Since the country of residence is effectively a taxpayer election as to which many countries acquiesce, there is international competition to attract multinational headquarter companies. A driving feature of this effort is the provision of incentives for such relocation. In this regard, the movement to a territorial model<sup>175</sup> reflects a determination by such residence countries to trade their theoretical ability to tax extra-territorial income to attract high-paying, white-collar headquarter and research jobs to their country. Any single country cannot realistically stand alone in the wake of this race to the bottom. An effort to do so is likely futile and serves only to disadvantage that country vis-à-vis competitive jurisdictions.

Accordingly, even if one accepts that residency-based taxation as a conceptual solution for homeless income in an ideal world, the real world has already largely abandoned the model.<sup>176</sup>

## 2. Source Country Perspective

A source country is likely to believe that it should be able to tax residual income arising from functional activity taking place in its country. This is reflected in the tax policies increasingly asserted by the BRICS countries.<sup>177</sup> The BRICS have recently announced an initiative to develop a cooperate approach on issues related to international taxation, transfer pricing, exchange of information, and tax evasion and avoidance.<sup>178</sup>

Source countries may be uniquely situated to enact tax rules that treat all economic competitors in its marketplace similarly.<sup>179</sup> For example, if a source country (such as Holdingland in *Illustration C*<sup>180</sup>) were concerned about the possibility that profits allocated to HoldCo might be homeless income, then it could adopt a rule to re-

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<sup>174</sup> The powerful tax benefits afforded to inversion transactions, in which a MNE changes its place of residence, inevitably for tax reasons, from a high tax to a low tax country, reflects that the last days of the existing paradigm are at hand as MNEs can self-help themselves into a territorial result either through their own inversion transactions or face the prospect of acquisition by foreign competitors. In either scenario, there will be an expansion of homeless income.

<sup>175</sup> See *supra* note 170.

<sup>176</sup> One element of a future treaty policy debate addressing homeless income will be the role of regimes that have evolved over the past 60 years to “backstop” the residence country tax bases out of concern that the TP rules were not adequate for this task. Such regimes include the so-called controlled foreign corporation rules of many residence countries, as well as other related regimes. It is to be hoped that an effective resolution of the homeless income matter would eliminate the need for these complex and overlapping regimes.

<sup>177</sup> See *supra* notes 7–8.

<sup>178</sup> See Press Info. Bureau, Gov't of India Ministry of Fin., *Heads of the Revenue of Brics Countries Identifies Seven areas of tax policy and tax Administration for Extending their Mutual Cooperation; joint Communique issued after Two Day meeting of the heads of Revenue of Brics Countries*, January 18, 2013 (announcing the cooperation agreement between Brazil, Russia, India, China, and South Africa), *reprinted at* 2013 WTD 15-27, Tax Doc. 2013-1498.

<sup>179</sup> The increasing boldness of source countries, particularly the BRICS, to apply their own transfer pricing rules is becoming increasingly obvious. See, e.g., Comm. of Experts on Int'l Cooperation in Matters, *Practical Manual on Transfer Pricing*, E/C.18/2012/CRP.1 (October 2012), available at [http://www.un.org/esa/ffd/tax/documents/bgrd\\_tp.htm](http://www.un.org/esa/ffd/tax/documents/bgrd_tp.htm). Chapters 1-9 of this manual were written by the UN Committee on Experts and the transfer pricing approaches advocated therein largely support the OECD approach to transfer pricing. Chapter 10 was written by select BRIC countries and the principles articulated in this chapter 10 are fundamentally inconsistent with the principles advocated in the first nine chapters.

<sup>180</sup> See *supra* Part II.A.

allocate any profits allocated to HoldCo back to ColonyCo if the HoldCo profits were not subject to meaningful resident country taxation.<sup>181</sup>

Alternatively, the source country could subject all 900 of profits in *Illustration C* to taxation by employing “force of attraction” concepts with foreign tax credit relief provided for taxes paid by Holdco in the resident country.<sup>182</sup>

### 3. *MNE Perspective*

MNEs reacted to the foundational premise in a manner to achieve their effective tax rate objectives, including taxing maximum advantage of the potential benefits of homeless income.

Can MNEs as a group accept a new paradigm that would eliminate, over time, the benefits of their homeless income generating models? Hopefully, the multinational community would be a willing and active participant in the process.<sup>183</sup> The ultimate concern of business is likely to be the presence of a level playing field, so that no one company is disadvantaged vis-à-vis its competitors due to geographic location or other non-business considerations.

### 4. *OECD/UN Perspective*

Homeless income has arisen from the structure of the existing model treaties, as discussed throughout this article. The OECD and UN have been the global leaders in treaty policy in modern times. Will they, together or separately, be willing to initiate or embrace an updating of model treaty policies to reflect the world of the 21st century?

## CONCLUSION

For the reasons noted immediately above, the treaty model of the post-World War I era is bound to undergo evolution. At this point in time, it appears that no group is happy with its consequences. The original residence countries have largely abandoned its benefit, source countries of the 1920s reject the model outright, the G-8 and G-20 have proclaimed that inappropriate effective tax rate policies have been spawned by the Foundational Premise, emerging countries and their supporters or financiers decry the impact of existing models upon their economic growth potential, and MNEs are stuck in the middle, pilloried for following the rules.<sup>184</sup> In short, the likelihood of future life of policies developed for the self-benefit of the economic powers of an earlier era (when airplanes were a novelty, Franklin Roosevelt and Winston Churchill were mere boys, and the sinking of the Titanic was recent, unbelievable news) seems remote.

In the inevitable re-examination process, there will be a fascinating range of political, economic, and business issues to be addressed. Tax administrations will need to ascertain how their resources can be redeployed to foster economic growth. MNEs will

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<sup>181</sup> Such a proposal would be very similar to the “throw-back rules” that apply in several states in the United States where income that is apportioned to a particular state is “thrown back” to the first state if the state of initial apportionment does not seek to tax such apportioned profits. *See generally* Walter Hellerstein, *The Quest for ‘Full Accountability’ of Corporate Income*, 63 ST. TAX NOTES 627 (2011); Hamilton, *MTC Launches Projects on Associate Nexus, Throwback Rule*, TAX ANALYSTS, Doc. No 2011-16136 (2011).

<sup>182</sup> Before the enactment of the Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539, a so-called “force of attraction” rule applied so as to tax all of the U.S. income as business income at graduated rates. *See generally* Thomas Bissell, *U.S. Income Taxation of Nonresident Alien Individuals*, 907 TAX MGMT. PORTFOLIO (BNA) at II.

<sup>183</sup> *See* Wells & Lowell, *supra* note 10.

<sup>184</sup> *See supra* Part XII.

need to assess the impact of new treaty concepts on their global effective tax rate planning models. Finally, organizations such as the OECD and UN will need to assess the impact of such developments on their own role in international taxation.

The critical question is who will initiate the evolution to come. All countries are anxious to protect their respective tax bases. At the present time, it appears that the BRICS and source countries have planted their stake in the sand, rejecting the existing order and declaring an intention to update the rules that apply to their own tax base defense. The OECD appears to be principally driven by the need to defend its member country tax bases, hoping, no doubt, that BRICS and source countries will ultimately follow its lead.<sup>185</sup> If it fails to heed the needs of the evolving order (BRICS and source countries), the hegemony of the OECD may be lost in the process.

As always, the study of history provides illumination for the future, provided that the lessons are not forgotten or ignored. The learning that can be derived from the policies developed in the 1920s is that tax revenues will follow treaty policy design.

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<sup>185</sup> See *supra* note 4.