The centennial of the four economists’ Report on Double Taxation (1923) (League of Nations, Economic and Financial Commission, Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, E.F. S.73. F.19 (League of Nations 1923) (the Report).) provides a good opportunity to reflect on the extent the international tax regime (ITR) that was founded on the Report has changed in the past decade. While on the surface the changes brought about by the Base Erosion and Profit Shifting (BEPS) project seem radical enough to consider them an ‘international tax revolution’, this article will argue that the principles developed in the Report are still influential a hundred years later.

1 INTRODUCTION

The Report originated with a request by the International Chamber of Commerce to the newly established League of Nations to study the problem of double taxation. The context was the sharp increase of income tax rates during World War I and the fear that tariff barriers and a retreat from globalization would restrict cross-border investment.

The Financial Committee of the League asked four economists in 1921 to study the issue: Prof. Bruins from the Commercial University in Rotterdam, Prof. Einaudi from Turin University, Prof. Seligman from Columbia University, and Sir Josiah Stamp from London University. Out of the four, only Prof. Einaudi represented a capital importing country, and he did not participate in the actual meetings of the committee. The inclusion of Prof. Seligman is remarkable because the United States had refused to join the League, but it was necessary because the US was already the world’s largest economy as well as a pioneer in relieving double taxation through the foreign tax credit, which it adopted unilaterally in 1919.

The committee met in Geneva in March 1923 and in April issued the Report, which was primarily drafted by Prof. Seligman, as shown by the repeated examples from US states, which only he could have been familiar with, as well as the citations from his books and the overall preference for ability to pay taxation, which was his major contribution to public finance.[1]

The Report is divided into three parts. Part I is an economic analysis of the consequences of international double taxation. Its main conclusion is that double taxation impacts existing cross-border investments and also deters new cross-border investment, and therefore should be avoided as much as possible. Part I also argues that in most cases the burden of double taxation is shifted to the residents of the source country because the investor will insist on receiving the world market return on its investment.

Part II discusses the general principles which govern international tax jurisdiction. It argues that the proper basis for income taxation is not an exchange of taxes for benefits conferred by the taxing government, but rather progressive taxation based on ability to pay. Part II also develops the concept of economic (rather than political) allegiance as the justification for tax and the consequent right of both domicile (residence) and origin (source) countries to impose tax.

Part III applies these principles to the avoidance of double taxation. It develops four methods to avoid double taxation: The credit method, under which the source country imposes tax and the residence country grants a foreign tax credit; the exemption method, under which the source country refrains from taxing the income of non-
residents; the formulary method, under which the tax is divided by an agreed upon formula between residence and source jurisdictions; and the classification and assignment method, under which income is divided into various categories and then assigned to either source or residence countries based on which one has the better claim to tax it.

Part III then sets out the practical application of these methods. It rejects the credit method as overly generous to source countries. It expresses a preference to the exemption method, but voices doubts as to whether it will be acceptable to source countries. It supports the formulary methods but points out that they require agreement between the respective jurisdictions. Finally, it settles on classification and assignment as the most likely method to be applied in practice. In addition, in the portion dealing with source taxation, the Report suggests that income derived from real estate and from business activities (active income) be taxed at source while income from investments (passive income) be taxed at residence. This part of the Report had the most immediate influence, because it was incorporated into the work of the technical experts who drafted the first model treaty in 1927.

In the following sections, the article will discuss whether the Report has a continuing relevance today given the dramatic changes in the international tax regime (ITR) in the last decade. Of course, even under BEPS, the basic architecture of the tax treaties will remain unchanged, and that classification and assignment scheme is directly derived from the Report. But I will argue that the impact of the Report is deeper than that and can be seen in both pillars of the new ITR.

2 THE REPORT AND PILLAR ONE:

Pillar One applies a formulary method to allocate a portion of the residual profits of large multinationals (Amount A) to the market jurisdiction. The main innovation in Pillar One is to recognize the right of the market jurisdiction to a portion of the profits of an entity that sells goods or provides services in it. To do so, Pillar One overrules the two main limitations on source taxation of active income included in the tax treaties, namely the permanent establishment (PE) threshold and the arm’s length standard (ALS). Neither of these limitations appears in the Report, since the PE threshold was derived from the nineteenth century tax treaties but was not considered generally binding until the models, while the ALS was only developed by Mitchell Carroll (the protégé of Seligman’s main rival Thomas Adams) in the 1930s.

What would the four economists have made of Pillar One? The general idea of formulary allocation by consensus is the third method they approved of to prevent double taxation. Thus, they would presumably have approved of its inclusion in Pillar One.

In addition, it is clear that they agreed that the market jurisdiction (‘the selling end, that is, the place where the agents for selling ply their calling and where the actual markets are to be found’) has the right to tax the income derived from sales into the market. The Report states that one of the bases of economic allegiance is the establishment and protection of the market, which confers benefits on the taxpayer:

The same is true of the benefits connected with the consumption side of faculty, where there is room even for a consideration of the cost to the government in providing a proper environment which renders the consumption of wealth possible or agreeable.

The Report further argues that the market jurisdiction is essential to the production of wealth:

By production of wealth we mean all the stages which are involved up to the point of wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth. The oranges upon the trees in California are
not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities. [4]

The Report is also clear that all of the countries that contribute to the production of income are essential and therefore should share in the tax imposed upon it:

It may be said that no one of these four elements can be omitted without ruining the efforts of the other three and spoiling the whole apparatus for the production of wealth. These have no relation whatever to the place where the final owner enjoys his income from the labours of the four elements. The four of them are thus in different measures related to the origin of the wealth, that is, its production as a physical product. [5]

The Report also recognizes that failure in selling goods or services can render all the efforts of previous stages of production irrelevant:

It may well be that productive operations up to a certain point have been well and profitably conducted and that the whole of the excellent results to this point are thrown away by bad selling. [6]

Thus, Pillar One reflects the ideas in the Report in two ways: First, by dividing up Amount A between the source and residence jurisdictions by formula, which is consistent with the third method of preventing double taxation ('the method of division of the tax'). Second, by acknowledging the right of the market jurisdiction to some of the tax upon the income derived from selling goods or services into the market.

We may have some indication of the origin of these elements in the Report. As the reference to California suggests, this section was likely first drafted by Prof. Seligman, who was familiar with US state methods of taxation. By 1923, over twenty US states used formulary apportionment to divide the corporate income tax base among themselves, and many of them (seventeen out of twenty-nine in 1929) used a sales factor as either one of the factors of the formula or even as the exclusive factor. [7] I would therefore suggest that US state practice influenced the Report (just like it influenced the adoption of the ALS in the 1930s, since Carroll explicitly discussed and rejected it in his voluminous report to the League on the allocation of income between related parties). [8]

3 THE REPORT AND PILLAR TWO:

The major contribution of Pillar Two is acceptance of the Single Tax Principle (STP), which states that cross-border income should not be subject to either double taxation or double non-taxation. This principle is implemented through an agreement on a minimum global corporate tax rate and the various practical steps to be adopted by residence jurisdictions Income Inclusion Rule (IIR) or source jurisdictions Undertaxed Profits Rule (UTPR) and Qualified Domestic Minimum Top-Up Tax (QDMTT) to enforce it in practice.

The focus of the Report was the prevention of double taxation. But what is remarkable is that the Report is also based on the assumption that all cross-border income should always be fully taxed, and therefore it implicitly adopts the STP. This can be seen most clearly in that the Report barely mentions the most common method in 1923 to prevent double taxation, namely that the residence county should exempt foreign source income.
This exemption method (to be distinguished from what the Report calls exemption, namely the abolition of source country taxes) was the practice of most European countries when the Report was written, but the Report explicitly does not include it among the methods it discusses to prevent double taxation.

The reason for this remarkable omission is that the Report is based on Seligman’s fervent advocacy for ability to pay taxation (rather than benefits based taxation which would have justified a territorial regime). The Report states that as far as income taxation is concerned,

> The ideal solution is that the individual’s whole faculty should be taxed, but that it should be taxed only once, and that the liability should be divided among the tax districts according to his relative interests in each. The individual has certain economic interests in the place of his permanent residence or domicile, as well as in the place or places where his property is situated or from which his income is derived.⁹

This preference for ability to pay taxation underlies the United States global system under which the income tax is imposed on ‘all income from whatever source derived’.¹⁰ If ability to pay is the foundational criterion for income taxation, then methods like exemption by the residence country must be rejected because they lead to double non-taxation whenever the source country does not tax, and the Report endorses full residence taxation and the abolition of source taxation as its preferred method for preventing double taxation.¹¹

This insistence on preventing double taxation only by methods which do not lead to double non-taxation can be seen throughout the Report. Consider, for example, the four methods advocated for the relief of double taxation. The first method is what we would call the credit method, as adopted by the US under the leadership of Seligman’s rival Thomas Adams:

> (1) A country might deduct from the tax due from its residents any tax paid by them on their income from abroad (analogous to the United States practice in the case of its own citizens). This throws the whole burden of increased taxation in debtor countries upon the creditor country, and is opposed to the general practice observed by foreign Governments when issuing their loans. If this course were followed,

Governments need no longer make provision for making the loans free of tax to non-resident investors, knowing that it will fall upon the exchequer of the creditor country. It is to be doubted whether such creditor countries as the United States, Great Britain and the Netherlands, having regard to their interests abroad, would ever agree permanently to put their exchequers at the mercy of all the unknown increases of taxation of foreign Governments. This may be called the method of deduction for income from abroad.¹²

The Report rejects this method, presumably because Seligman, Bruins and Stamp did not favour it (note the reference to their countries) because of the revenue impact on residence countries, but it also accepts it as a valid method of full ability to pay taxation.

The second method advocated by the Report involves the source countries giving up tax jurisdiction, so all income is taxable in full by the residence country:

> (2) The extreme converse, viz.: that the country of origin should exempt all non-residents from taxation imposed on income drawn from sources within its borders, recognises the theoretical fact
that the country wanting the money cannot successfully “tax the foreigner”; it can only shut him out. It would have the effect of increasing the flow of capital from abroad and the development of less-favoured regions. This may be called the method of exemption for income going abroad. [13]

This is the method favoured by the Report as most consistent with ability to pay, and it clearly envisages full taxation by the residence country. However, the Report acknowledges that source countries are unlikely to fully give up on their right to tax foreigners, however economically ill-advised such a course of action may be:

A survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner. It seems to be clearly instinctive in laying down general principles to treat "origin" as of first importance, and residence as of "secondary" importance; i.e., if the origin and source of income are within a country’s borders, it is assumed that country has the prime right of taxation on that income, although it goes to some person abroad. There are a few modifications, but this is the main instinctive principle. From this follows the consequence that, when double taxation is involved, Governments would be prepared to give up residence rather than origin as establishing the prime right.[14]

This is the only reference in the Report to the possibility of a pure exemption system (i.e., exemption by the residence jurisdiction) and it is unequivocally repudiated because it leads to double non-taxation and is based on outdated benefit-based notions of taxing rights that should over time be eliminated [15].

The third method the Report approves of is division by formula:

(3) It may be possible by convention to divide specific taxes so that a portion should be borne by the country of origin and the remainder by the country of residence … This is an attempt to recognise both principles and to spread the burden upon the two Governments. It would leave in an unsatisfactory position issues of State loans, and is open to many of the objections, though not to the same extent, as those raised to the first proposal. This may be called the method of division of the tax.

This method as well envisages full taxation because the tax revenue is divided between the taxing jurisdictions. In fact, the Report emphasizes that this method should never be used in a way that reduces tax below what it would be if there was only domestic income (e.g., if the source rate is below the residence rate). This result is achieved by not applying the agreed upon formula to the tax base but rather to the revenues from the tax, so that the rate is assumed to be the same in both countries:

Now it is of the essence of this method that the resident shall not gain by the relief in double taxation, that is, shall not be in a better position than he would be if his income were all derived in the country where he resides. Relief is desired only to the extent of the excess over such a sum; and therefore the essence of method 3 is that the country of residence should give relief by a definite amount that has been levied in the country of origin, with, if it is desired, a maximum for that relief equal to one-half of the rate of tax levied by the country of residence.[16]
By convention it might be determined to attach origin taxation specifically and wholly to particular classes of investments or embodiments of wealth, such as rents of land and of houses and mortgages on real property, but to exempt the non-resident in respect of income derived from business securities. The country of residence would allow the whole of the foreign tax as a deduction from its income tax on the resident in respect of such sources of income, but would charge other sources in full. The country of origin would retain its specific origin taxes in full. It would be necessary to give the country of residence complete power of charging all sources except for certain specified exemptions, so that the scope of its liability to remit the tax would be easily determined, and the investor, from his total income-tax demands, would be able to deduct certain specified taxes on any real property he might have. It might be desirable to impose some limit upon the power of the country of origin to levy in future specially heavy specific origin taxes, which would unduly deplete the exchequer of the country of residence. This may be called the method of classification and assignment of sources. [17]

Here too is the emphasis on full taxation, in this case by either the county of residence or the county of source depending on the type of income involved.

The problem with this method, as adopted in the treaties, is that unlike the other three (but like the rejected exemption by the residence country method) it gives the source jurisdiction the exclusive right to tax certain types of income, and so to the extent it does not do so, the principle of taxation based on ability to pay is violated. That is presumably one reason why the Report prefers for both methods 3 and 4 to have full taxation by the residence country and then a sharing of the proceeds with the source country, rather than exclusive taxation by the source country.

To sum up, the Report implicitly endorses the idea of full taxation (i.e., the STP) and explicitly rejects the most common method of preventing double taxation prevalent at the time, namely the exemption of foreign source income by the residence jurisdiction. In this way, it is consistent with Pillar Two as well as with the original statement of the STP in the preamble to the 1927 model.[18]

4 Conclusion

As we reach the centennial of the Report, its continuing influence can be seen despite the radical changes in the ITR in the past decade. Specifically, the Report is congruent with Pillar One in its acceptance of formulas as a valid method of allocating income among taxing jurisdictions and in its acceptance of the right of the market jurisdiction to tax income from sales into it. The Report is congruent with Pillar Two in its insistence on full taxation of cross-border income. In this general sense, it can truly be said about the ITR that ‘plus ca change, plus c’est la meme chose’.

Footnotes

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2 Report, 24.

3 Report, 18.

4 Report, 23.

5 Report, 24.


9 Report, 20 (emphasis added). The Report does not discuss corporate taxation, but the same principles can be applied to it if one accepts (as the Report does not) that corporations are a valid object or taxation.

10 US Constitution, Am. XVI.

11 ‘On the subject of income taxation in its developed form, the reciprocal exemption of the non-resident under method 2 is the most desirable practical method of avoiding the evils of double taxation and should be adopted wherever countries feel in a position to do so’. Report, 46.

12 Report, 43.

13 Ibid.

14 Report, 24.

15 ‘Looking forward to the future, the influence of example by others and the spirit encouraged by the operations of the League of Nations indicate the possibility of a development away from localised ideas and from the earlier stages of economic thought typified by strict adherence to the principle of origin. Moreover, as semi-developed countries become more industrialised, with the resulting attenuation of the distinctions between debtor and creditor countries, the principle of personal faculty at the place of residence will become more widely understood and appreciated and the disparity between the two principles will become less obvious, so that we may look forward to an ultimate development of national ideas on uniform lines toward method 2, if not as a more logical and theoretically defensible economic view of the principles of income taxation, at least as the most practicable solution of the difficulties of double taxation’. Report, 47.

16 Report, 46 (emphasis added).

17 Report, 43 (emphasis added).

18 ‘From the very outset, [the drafters of the model convention] realized the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international cooperation should prevent certain incomes from escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and only once’. Report prepared by the Committee of Experts on Double Taxation and Tax Evasion (League of Nations Publications 1927), at 23.