Disentangling Taxation Rights Rules in Business Taxation: Tracing the Work of International Organisations

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The international effort to coordinate tax rules across nations began nearly a century ago, originally aimed at eliminating double taxation. The effort was expanded to tax business profits on a more consistent basis worldwide. However, these rules have changed over time without a solid foundation of clear and coherent principles, causing schisms in dealing with multiple taxpaying entities and intragroup transactions. While the Organisation for Economic Co-operation and Development (OECD) has a large-scale initiative underway to reset international tax norms to prevent base erosion and profit shifting, the initiative is unlikely to settle the tax challenges of the 21st century since it is likely to create further conceptual distortions. This article tracks the historical development and evolution of international tax rules related to business profits set out by the League of Nations, the Organisation for European Economic Co-operation (OEEC), the United Nations (UN) and the OECD. The fragmented approach to a narrow set of problems demonstrates that cooperative international tax settlement is far from over. A better alternative for business taxation would begin with removal of the concept of corporate residence, followed by reconceptualisation of base allocation rules to determine the jurisdictions to tax.

1.0 INTRODUCTION

Policymakers have long grappled with the trade-off between tax collection and the removal of double taxation. With increasing international trade and investments, tax competition intensified; different jurisdictions instituted preferential tax regimes to attract foreign investment.[1] This created an opportunity for multinational enterprises to divert their profits to no- or low-tax jurisdictions and subsequently raised concerns for social fairness.[2]

In 2013, the Organisation for Economic Co-operation and Development (OECD) launched the Base Erosion and Profit Shifting (BEPS) initiative to address, among others, the profit-shifting of multinational enterprises.[3] It was claimed that some international tax rules were considered outdated, if not deficient, to facilitate profit shifting between jurisdictions where there was no or little substantive changes in economic

1 See, eg, Philipp Genschel and Thomas Rixen 'Settling and Unsettling the Transnational Legal Order of International Taxation' in Terence C Halliday and Gregory Shaffer (eds) *Transnational Legal Orders* (Cambridge University Press, 2015).

2 It is often claimed that multinational enterprises do not pay their fair share of tax, hence infringing social fairness, although their tax planning strategies are legitimate. This dilemma was disputed in the Public Accounts Committee Meeting on Taxation of Multinational Corporations in the presence of Matt Brittin (CEO, Google UK), Troy Alstead (Global CFO, Starbucks), and Andrew Cecil (Director Public Policy, Amazon) on 12 November 2012. The recording can be found on <www.parliamentlive.tv/Event/Index/ab52a9cd-9d51-49a3-ba3d-e127a3af018c>.

3 OECD *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013) (*OECD Action Plan*).

or financial activities.[4] As part of the project, taxation right allocation rules embodied in the standard tax treaty provisions and cross-national tax rules were revisited, followed by the introduction of a multilateral instrument (MLI)[5] to override many existing tax treaties and the Inclusive Framework (IF)[6] to implement recommended solutions in addressing the tax challenges arising from digitalisation and globalisation of the economy.

To apprehend the continual changes in the international tax sphere, this article examines the taxation right assignment rules governing corporate profits as they were promoted by international organisations and proposes coherent and logical guidelines for conceptualising international tax rules with consideration of the OECD's current efforts to resolve 21st Century tax challenges. The article observes historically significant conceptual underpinnings of taxation right rules, without in-dept discussion about the technical interpretation or practical applications of taxation treaties, to provide a better understanding of the current form of international tax norms, as well as modern concerns about them.

This article is structured as follows. Section 2 begins with the doctrine of economic allegiance, which was developed by four economists under the auspices of the League of Nations in the 1920s. The doctrine provided a conceptual framework for assigning taxation rights, principally based on origin and domicile. Section 3 discusses deviations from the doctrine of economic allegiance, which arose through negotiations of model tax conventions drafted by the League of Nations, Organisation for European Economic Co-operation (OEEC), OECD and United Nations (UN).

For the first half of the last century, the work of those organisations focused primarily on the prevention or elimination of double taxation through taxation treaties. However, an increasing treaty network was followed by increasing tax competition and various ways of structuring global operations to minimise the overall tax liability. Section 4 shows this phenomenon, with renewed interest in *single taxation* – that is, taxation of (business) profits only once – under the BEPS project. This project addresses the global tax system coordination beyond tax treaty modifications. Many countries, including some outside the OECD, are currently involved in the IF to establish consensus-based international tax regimes.[7]

However, these developments have encountered pointed criticism. To give a few examples, first, the dual problem of double taxation and double non-taxation cannot be resolved simultaneously without standardisation of cross-national tax rules.[8] Such standardisation requires a sacrifice of tax sovereignty, which in turn may impede economic development of developing countries that require foreign capital investment.[9] Second, single taxation, albeit an attractive concept, is not clearly defined in terms of the tax base and the tax rate. Moreover, tax terminologies, such as tax evasion, tax avoidance and aggressive tax planning, are not always interpreted consistently in different jurisdictions, which hinders the coordinated effort to devise effective international tax rules. Third, proposed solutions under the IF are narrow in scope, only applying to significantly large enterprises, and prescriptive in introducing new tax bases – namely,

4 Michael J Graetz "The David R Tillinghast Lecture Taxation International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) 54(3) Tax Law Rev 261.

5 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016.

6 The IF to a two-pillar solution is currently in progress. See the progress on OECD *Planned Stakeholder input in OECD Tax Matters* <www.oecd.org/>.

7 Above n 6.

8 Philipp Genschel and Thomas Rixen "Settling and Unsettling the Transnational Legal Order of International Taxation" in Terence C Halliday and Gregory Shaffer (eds) *Transnational Legal Orders* (Cambridge University Press, 2015) 157.

9 See, eg, L Wagenaar "The Effect of the OECD Base Erosion and Profit Shifting Action Plan on Developing Countries" (2015) 69(2) *Bulletin for International Taxation* 84.

destination-based taxation and global minimum taxation. It has been widely appealed that complexity can create novel and more complicated forms of tax planning.[10]

Finally, Section 5 summarises the preceding with high-level recommendations to address tax challenges. From a conceptual standpoint, the recommendations include removing the concept of corporate residence, reconceptualising deductible payments, such as interest, royalties and intragroup management or service fees, and introducing new taxation right allocation rules that enable the sharing of taxes between the State of origin and the State of destination. They would make international taxation simpler and more neutral.

2.0 THE DOCTRINE OF ECONOMIC ALLEGIANCE

Traditionally, taxes were levied on persons who had political allegiance to the State. In the late 19th Century, scholars began departing from this notion to propose the taxation based on economic allegiance. For example, Schanz and Seligman were prominent in this regard, to promote taxation based on *origin* for income and the *situ* for property.[11]

The League of Nations commissioned four prominent economists: Professors Bruins (Commercial University, Rotterdam), Senator Einaudi (Turin University, Italy), Seligman (Columbia University, New York) and Sir Josiah Stamp, KBE (London University, Great Britain). They studied the economic consequences of double taxation and formulated general principles for tax agreements. Their report, published in 1923,[12] described the principles of economic allegiance as 'the starting-point of the modern theory';[13] however, the report redefined the substance of economic allegiance.

The economists' premise was that taxation must be based on one's ability to pay (hereafter, "faculty theory").[14] Faculty theory was considered more comprehensive than the alternative benefit theory, which holds that taxes should be paid according to the services performed or benefits provided by the government.[15] The use of faculty theory was intended to provide detailed accounts of the benefit theory,[16] not to address national or international income inequalities.

Faculty theory subsequently allowed the consideration of *domicile*, referring to 'permanent or habitual residence',[17] as an element of economic allegiance. Conversely, the traditional jurisdiction to tax was based on political allegiance, which was rejected on the basis that citizenship was mitigated by increasing international mobility, so was the temporal place of abode, which was rejected because it is merely incidental.[18]

10 See, eg, Wolfgang Schön "Is There Finally an International Tax System?" (2021) 13(3) WTJ 1 at 4.

11 See Georg von Schanz "Zur Frage der Steuerpflicht" (1882) 8 *Finanz-Archiv* 365; Edwin R A Seligman *Essays in Taxation* (New York City, 1895).

12 G W J Bruins et al *Report on Double Taxation*, League of Nations Doc E.F.S.73. F.19 (5 April 1923) *(League's Report 1923*). The report initially received some criticism. See, eg, W B Cowcher "League of Nations: Economic and Financial Commission" (1923) 33(132) Econ J 566 at 571 (raising scepticism about whether the doctrine of economic allegiance would ever become a dominant principle of international tax rules); W H Coates "League of Nations Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp" (1924) 87(1) *Journal of the Royal Statistical Society* 99 (pointing out the lack of coherence of the report).

13 *League's Report 1923*, above n 12, at 20.

14 *League's Report 1923,* above n 12, at 20 ("this doctrine is given quantitative expression by reference to terms of economic faculty or ability of the individual to pay").

15 *League's Report 1923,* above n 12, at 18–22.

16 Later, the use of taxation to redistribute income complicated the international tax debate although it cannot be a proper basis for settling international tax rules at the international level. See Seizaburo Sato "Democracy and Market Economy" (2010) 7(1) Asia Pac Rev 2 at 11 (pointing out the unrealistic objective to correct societal inequalities worldwide).

17 *League's Report 1923,* above n 12, at 25.

18 *League's Report 1923,* above n 12, at 19.

The four bases prescribed as the jurisdiction to tax based on economic allegiance were: (1) the place where wealth was produced; (2) the *in situ* of wealth; (3) the place where the rights to wealth were enforced; and (4) the place where wealth was utilised. The first and the last, referring to *origin* and *domicile*, respectively, were the primary considerations for assigning taxation rights.[19] Conversely, the economists said that the third (the location of wealth) and fourth (enforceability of property rights to the wealth) would strengthen claims of the first and second bases and potentially become crucial in certain circumstances.[20]

It was said that the origin of the wealth should be determined with consideration of the *in situ* property and any personal social networks involved in the production of the wealth, such as superintendents, agencies for transportation, controlling entity (or the enterprise's coordinating mind) and selling agents.[21] This view was consistent with the principles of economic allegiance illustrated by Schanz and Seligman earlier. However, the economists advanced that the place of domicile, where wealth was consumed, wasted or reinvested, was also important to give a taxing right.

The four elements of economic allegiance were evaluated regarding 12 defined categories of wealth. One way to balance different elements of economic allegiance would be to share taxation between States that contributed to the creation of wealth by way of, for example, allocating percentages between them. However, the economists considered that this was arbitrary and challenging in practice.[22] They emphasised selecting the dominant element of economic allegiance for each wealth category to assign taxing jurisdictions.

In general, origin prevailed for tangible assets.[23] Origin-based taxation was applicable for the profit generated from land use and an enterprise's derived profit. An enterprise was typified into three categories: a business directly dependent on land or land resources, an industrial establishment with factories, and a commercial establishment where land or fixtures are not a substantially significant production factor. For the first and second categories, the origin of wealth was considered a more appropriate taxing basis owing to its attachment to the land; for the third category, origin-based taxation was assumed to fit by giving weight to the location of productive activities.[24]

The categories of assets recommended for domicile-based taxation included the income derived from real estate mortgages, corporate securities, government bonds and private credits where investors loaned or saved capital.[25] Cockfield asserts that allocating tax rights based on domicile for these kinds of assets meant attracting investment from foreign countries could be costly.[26] However, he understood that the economists nevertheless favoured domicile-based taxation for the following reasons: "(a) it would encourage more investment in these countries; (b) mechanisms could be created to give them a residual right to tax certain streams of income at the source; (c) government fiscs could negotiate end-of-year transfers to make up for revenue losses; and (d) as developing nations became more industrialized the capital flows would become

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19 *League's Report 1923,* above n 12, at 25. Note origin and domicile are not absolutely coextensive as the origin of an asset can be situated in a different place to where the asset is ultimately located to be utilised or disposed.

20 *League's Report 1923,* above n 12, at 25.

21 *League's Report 1923,* above n 12, at 24.

22 *League's Report 1923,* above n 12, at 39.

23 See the summary in *League of Nations*, above n 12, at 39. Origin-based taxation applies to all corporeal or tangible classes of wealth, other than money, jewellery, furniture and any such movable property of a personal nature. See the summary in above n 12, at 39.

24 *League's Report*, above n 12, at 29–31.

25 In general, domicile-based taxation applies to all incorporeal or intangible wealth except mortgages connected to land and improvements to land. Domicile-based taxation was also suggested for professional earnings. See the summary in *League of Nations*, above n 12, at 39.

26 Arthur Cockfield "Purism and Contextualism within International Tax Law Analysis: How Transitional Analysis Fails Developing Countries" (2007) 5(2) eJlTaxR 199 at 204.

more balanced".[27] The economists expected that capital flows would eventually be balanced as capital importing countries became more industrialised.[28]

Between origin and domicile taxation, the economists favoured the latter in removing double taxation. To remove double taxation, they examined four methods: (1) deduction for income from abroad; (2) exemption for income going abroad; (3) division of tax; and (4) classification and assignment of the source.[29]

The first method gives primacy to origin taxation, with the country of domicile providing tax relief for taxes paid or payable in foreign countries. The second method allows domicile taxation by removing all taxation of the persons who have no domicile within the State. The third method provides that specific taxes should be shared between the State of origin and the State of domicile – for example, a 50:50 split between the State in which a shareholder has domicile and the State in which the corporate profit originates. The fourth method allows origin taxation, wholly or specifically, regarding the classes of wealth and requires the State of domicile to deduct taxes paid in the State of origin.

The economists considered the fourth method as being the theoretically soundest but too difficult to apply in practice.[30] It would give no quantitative character to apportion income according to diverse sources. Although wealth may be apportioned so that the business profit is shared between states, say, 50:50, this was considered troublesome given the conventions with other countries.[31]

In the third method, apportionment would be arbitrary. The practical difficulty of applying the third method would have been compounded when the shareholder receiving a dividend does not know how the State of origin calculates tax relief.[32] If the profit is derived from operations in multiple jurisdictions, tax relief must be determined regarding the operations in all those jurisdictions. Tracing the sources of dividends poses significant challenges, and the amount of dividend may not even be the same as the amount of the business profit from which the dividend was declared in the taxing jurisdiction of the profits.[33]

Without detailed explanation, the first method was unanimously rejected as being "no complete and proper solution of the matter".[34] The economists concluded that the second method was preferred, giving reasonably similar results to the third or fourth method without posing significant practical difficulties. More specifically, the rationale for this choice was stated as "[f]irst, that it accords with what Governments are doing to-day so far as the money that they cannot get themselves is concerned, and that it only requires an extension of a Government's solicitude beyond its own needs to those of its own industries; secondly, that it accords with the true economic interests of the investments of the country; and, thirdly, that it is the best escape from all the complications of methods of greater theoretical exactness."[35]

27 Above n 26, at 204.
28 League of Nations, above n 12, at 48.
29 *League's Report 1923,* above n 12, at 42.
30 *League's Report 1923,* above n 12, at 51 ("We hold out no hopes of this proving to be a smooth and practical arrangement. It can only approximate and not an instrument of that degree of sensitiveness and accuracy which developed communities expect.")
31 *League's Report 1923,* above n 12, at 45.
32 *League's Report 1923,* above n 12, at 46–47.
33 *League's Report 1923,* above n 12, at 47.
34 *League's Report 1923,* above n 12, at 48.
35 *League's Report 1923,* above n 12, at 48.

3.0 MODEL TAX CONVENTIONS

In the early 1920s, impersonal taxation (*impôt reels*) was the standard type of taxation,[36] whereas only a few countries such as Great Britain, the United States and the German Empire had implemented personal or general taxation to tax on income from all, if not nearly all, sources.[37] Similarly, tax treaties were designed to remove double taxation in respect of different types of income. The League of Nations followed it to draft its model treaty, where it noted that the schedular system survived because it was administratively practical and capital importing countries would want to tax income in their territory.[38] This was despite the warning by Sir Percy Thompson that classifying assets into real or personal taxation could result in skewed economic data.[39]

Significantly, it was difficult to receive wide adoption of full domicile-based taxation because many treaties allowed origin-based taxation. Subsequently, two methods were suggested to relieve double taxation.[40] The first was the *deduction* (or *credit*) method that reduces the amount of personal tax in the State of domicile by the tax on the income subject to tax in the State of origin or by the tax paid abroad. The second was the *exemption* method, which excludes income subject to tax in the State of origin from taxable income in the State of domicile.

Initially, the deduction method was adopted with a limit on the lesser amount of tax payable in the State of origin or the tax paid in that State.[41] However, the real-life use of both methods led to the acceptance of both methods, leaving the choice between the two up to the contracting States.[42]

While the methods to reciprocally remove double taxation have been agreed relatively easily, reaching agreements for assigning taxing rights of business profits was not simple in the schedular system of taxation treaties. Different views were espoused regarding several matters, including whether taxation should be at source, which activity or conduct provides a sufficient contact to facilitate the taxation at source, and whether any limitation should be given to source taxation.

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36 Impersonal taxation is defined as ‘a series of separate taxes imposed on different types of income on a source basis, such as a tax on land, a tax on business profits and the like’: see John F Avery Jones “The David R Tillinghast Lecture — Are Tax Treaties Necessary” (1999) 53(1) Tax Law Rev 1 at 12.

37 *League's Report 1923,* above n 12, at 45. Netherlands had partial personal taxation: see John Taylor “Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks Sustainable?” (2010) 34(1) MULR 268 at 271.

38 *League's Report 1923,* above n 12, at 15.

39 Technical Experts to the Financial Committee *Double Taxation and Tax Evasion* League of Nations Doc F.212 (February 1925) at 15 (*League's Report 1925*).

40 Committee of Technical Experts *Double Taxation and Tax Evasion* League of Nations Doc C.216.M.85 (12 April 1927) at 16 (*League's Report 1927*). This report contains the Draft of a Bilateral Convention for the Prevention of Double Taxation (hereafter, League of Nations, Draft of a Bilateral Convention for the Prevention of Double Taxation (1927)).

41 League of Nations Draft of a Bilateral Convention for the Prevention of Double Taxation (1927) art 10.

42 OECD, Model Tax Convention on Income and on Capital (2017) arts 24A (exemption), 24B (credit); UN, Model Double Taxation Convention between Developed and Developing Countries (2017) arts 24A (exemption), 24B (credit). These models explain two deduction methods and two exemption methods. The two deduction methods are named (1) full exemption method and (2) exemption method with progression. To explain, consider a sum of $100,000 that is taxable in the country of residence, with $20,000 taxable in the country of source. The full exemption method provides that tax is imposed on $80,000 in the country of residence as if the only income earned by the resident is $80,000. Under the exemption method with progression, however, a tax rate applicable to $100,000 is used to tax $80,000 to prevent taxpayers from taking advantage of a lower tax rate applicable to $80,000. The two exemption methods are (1) full credit method and (2) ordinary credit method. Beginning with the tax liability on the worldwide income of $100,000, the full credit method reduces the tax liability by the amount of the tax paid in the country of source dollar to dollar. Under the ordinary credit method, this reduction only goes up to the amount of the tax attributable to the income taxable the country of source. The latter is relevant in a situation where the country of source imposes a higher tax rate than the country of residence. By applying the latter, the overall tax liability is the same, regardless of whether a taxpayer is subject to tax in foreign jurisdictions.

3.1 The League of Nations

The meaning of "permanent establishment" (PE) is important in origin-based taxation of business profits. Resolving the definition of PE was thus one of the original focusses in the development of model conventions. This was followed by the work aimed at fair profit allocation or apportionment between jurisdictions. Alongside, the League of Nations worked towards the coherent interpretation and definition of various terminologies such as "enterprise" and "fiscal domicile". As domicile-based taxation of artificial entities were recognised with their PEs being treated as separate taxpaying entities based on sources of their income, intragroup transactions such as head office fees, interest, dividends and royalties became important to ensure no arbitrary profit shifting. The taxing right conflict between origin and domicile led to the production of two separate drafts. However, before those drafts were harmonised, the League of Nation was dissolved in 1946.

3.1.1 Concept of PE: 1920s – early 1930s

Following the release of the economists' report in 1923, the League of Nations called experts from seven member countries[43] (called, the Group of Technical Experts) and tasked them to carry out further studies. The experts produced a report in 1925,[44] adopting the doctrine of economic allegiance in a modified form. Modifications were influenced by the domestic laws and treaties of member countries,[45] as well as the resolutions reached under the leadership of the International Chamber of Commerce.[46]

The significant obstacle to adopt the 1925 report was the support for domicile taxation that was not general tax practice. The domicile-origin conflict arose over certain classes of income, whereas, insofar as commercial or industrial activities were concerned, consensus was reached in principle that origin taxation be adopted – that is, business profits shall be taxed in the State in which commercial or industrial establishments were located.[47]

In dealing with business profits, the definition of PE could be drafted in one of two ways. The first, based on German treaties of the Continental European style, was to set out conceptual guidelines to seek a fixed physical location and the permanence of activities, to tax business profits visible to tax authorities.[48]

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43 Seven member countries were Belgium, Czechoslovakia, France, Great Britain, Italy, Netherlands and Switzerland. The United States was also invited to nominate a representative but did not respond to the invitation as it had rejected membership in the League. See further Mitchell B Carroll "International Tax Law: Benefits for American Investors and Enterprises Abroad: Part I" (1968) 2(4) *The International Lawyer* 692 at 693.

44 *League's Report 1925*, above n 39.

45 The committee examined the domestic laws of Belgium, Netherlands, Switzerland, the United States, Great Britain and its Dominions; it considered the bilateral conventions entered between Central European States before and after the war, the multilateral Rom Convention entered by Austria, Hungary, Italy, Poland, the Kingdom of Serbs, Croats and Slovenes and Roumania, and the special treaty agreed between Czechoslovakia and Italy. See the summary of the League's work between 1923 and 1925 at "Personality, Politics, and Principles" in Sunita Jogarajan *Double Taxation and the League of Nations* (Cambridge University Press, 2018).

46 During its London Congress held in 1921, the International Chamber of Commerce (ICC) produced general principles to be used in international tax agreements. These principles were communicated with the League in March 1923. In April 1924, the ICC sent a delegation to the League to explain its view and resolutions passed in March 1924. The League's Committee on Double Taxation and Tax Evasion established subsequent to the economists' work considered collaboration with the ICC but decided only to evaluate its resolutions. It did not revisit the potential collaboration with the ICC. See more information about the ICC's involvement in double taxation in Ke Chin Wang "International Double Taxation of Income: Relief Through International Agreement 1921–1945" (1945) 59(1) Harv Law Rev 73.

47 *League's Report 1925*, above n 39, 31.

48 Arvid A Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law and Taxation Publishers, 1991) at 77.

Alternatively, a list of examples could be given, like typical Anglo-Saxon treaties did.[49] The first model convention drafted by the League of Nations in 1927 followed the latter, providing the following:

> The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that the undertaking has business dealings with a foreign country through a *bonafide* agent of independent status (broker, commission agent, etc), shall not be held to mean that the undertaking in question has a permanent establishment in that country.[50]

Notably, independent agents were excluded from the definition of PE above. This was because the International Chamber of Commerce, caring for the domestic laws of the United Kingdom, made a reservation that commission agents were not an integral part of the enterprise.[51] The definition was subsequently modified in response to the disagreements of member countries and with the actual treaty practice. The League of Nations released updated drafts in 1928, 1931 and 1933, through which the definition of PE was substantially redefined.

The 1928 updates were drafted after the World Conference was held to discuss the 1927 draft. The conference was not successful because of confusion caused by different tax systems and the terminologies used in the 1927 draft.[52] The 1928 updates came in the form of three separate models: the first was taken from the 1927 draft; the second made reference to the types of assets without distinguishing between real and personal taxes; and the third, considering different fiscal systems, allowed tax on investment income in the State of domicile.[53] Where the definition of PE was identical in all three drafts,[54] there was a notable change made to the 1927 draft. That is, “affiliated companies”, whether subsidiaries or parent companies, were excluded in the 1928 drafts; a PE could not be established merely by reason of having an affiliated company. That said, no distinction was made between natural persons and legally constituted entities to specify a taxpayer in the drafts.

The Amsterdam Congress of the International Chamber of Commerce was held in 1929.[55] In response to the resolutions reached in the Congress, the League of Nations produced a new set of *multilateral* model tax conventions in 1931,[56] as it conceded that bilateral taxation treaties were only a partial solution to the problem of double taxation. The definition of PE in all three drafts was identical, again.[57] However, compared to the earlier drafts, the 1931 drafts omitted the “real centres of management”. Skaar claims that this was “presumably because these places of business normally constitute the fiscal residence of companies”, although the drafts made no distinction between natural persons and corporate entities.[58] This omission was temporary, however. The real centres of management were included in the 1933 draft.[59]

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49 At 77.
50 League of Nations, Draft of a Bilateral Convention for the Prevention of Double Taxation (1927) art 5.
51 Skaar, above n 48, at 82.
52 At 85. Representatives from 27 countries and the ICC attended the conference.
53 General Meeting of Government Experts on Double Taxation and Tax Evasion, *Double Taxation and Tax Evasion*, League of Nations Doc C.562.M.178 (31 October 1928) (containing League of Nations, Draft Model Treaty No. 1A, 1B and 1C (1928)).
54 League of Nations, Draft Model Treaty No 1A (1928) art 5; League of Nations, Draft Model Treaty No 1B (1928) art 2(B); League of Nations, Draft Model Treaty No 1C (1928) art 3.
55 ICC *Resolutions Passed at the Amsterdam Congress Supplement No 1 to World Trade* (1929).
56 Fiscal Committee *Report to the Council on the Work of the Third Session of the Committee*, League of Nations Doc C.415.M171 (6 June 1931).
57 At 8, 14, 16 (art 4).
58 Skaar, above n 48, at 86.
59 League of Nations, Draft Convention (1933) art 2(c) (contained in Fiscal Committee *Report to the Council on the Fourth Session of the Committee*, League of Nations Doc C.399.M.204 (26 June 1933) annex.

The 1933 draft provided guidelines for profit allocation, operating in addition to the 1928 drafts. In this draft, the definition of PE distinguished dependent agents of an enterprise from independent agents by whom an enterprise does not establish a PE. Although the express distinction appears to narrow down the scope of origin taxation on PEs, this distinction commonly appeared in taxation treaties by that time.[60]

The 1933 draft also expressly excluded subsidiary companies from the definition of PE. Two rationales are possible for this exclusion. First, it was inspired by the United States-France treaty of 1932.[61] Second, doing so would make it consistent with the newly inserted definition of fiscal domicile of an enterprise in the draft.

3.1.2 Defining (fiscal) domicile of an enterprise: mid-1930s

During consultation for drafting the 1927 Convention, the Group of Technical Experts who produced the 1925 report suggested defining corporate residence as the place where "the head office is situated or, if that office is not the real centre of management and control of the undertaking, the State in which this centre is situated".[62]

The League of Nations did not include any definition of fiscal domicile for companies and corporate bodies in the earlier drafts. This may be explained by the fact that origin taxation was suggested for business profits based on the connections with land or location-specific assets. Also, countries such as Great Britain and Australia had not introduced the comprehensive corporate income taxation to tax on diverse foreign source income until the 1930s.[63]

The definition of fiscal domicile for artificial persons appeared in the 1933 draft. In this draft, fiscal domicile was defined as the place where "an enterprise has its real centre of management",[64] where an enterprise included "every form of undertaking, whether carried on by an individual, partnership, corporate or any other entity".[65] The 1933 draft was not intended to change the application of the earlier 1928 drafts but added the way in which profits could be allocated between jurisdictions in a more consistent manner. It incorporated the profit allocation principles outlined in the report written by Mitchell B Carroll in 1933.[66]

Carroll was a former special attorney in the Treasury Department of the United States. He carried out extensive studies on the taxation of foreign enterprises, for which he personally visited 27 countries.[67] In his 1933 report, Carroll suggested a uniform definition of the fiscal domicile of legal entities as the real

60 Skaar, above n 48, at 86.

61 Carroll, aboven 43, citing Income-Tax Convention, with Protocol, USA-France, signed 27 April 1932, TS 885 (entered into force 1 January 1936).

62 *League's Report 1925*, above n 39, at 34.

63 See, eg, Taylor, above n 37, at 289.

64 League of Nations, Draft Convention (1933) Protocol art 2(b).

65 League of Nations, Draft Convention (1933) Protocol art 2(a).

66 The entire report contained five volumes. The first three volumes discussed the fiscal systems of 35 countries. The fourth volume synthesised the first three with suggestions for allocating business profits under tax treaties. The last volume was written by Ralph C Jones, which dealt with accounting methods of recording business profits.

67 See the background of Carroll's studies in Carl Shoup "Reviewed Work(s): Taxation of Foreign and National Enterprises. by League of Nations: Vol I: France, Germany, Spain, the United Kingdom, and the United States of America by League of Nations: Vol II: Austria, Belgium, Czechoslovakia, Free City of Danzig, Greece, Hungary, Italy, Latvia, Luxemberg, Netherlands, Rumania, and Switzerland. by League of Nations: Vol III: British India, Canada, Japan, Mexico, Netherlands, East Indies, Union of South Africa, States of Massachusetts, of New York, and of Wisconsin. by League of Nations: Vol IV: Methods of Allocating Taxable Income. by Mitchell B Carroll and League of Nations: Vol V: Allocation Accounting for the Taxable Income of Industrial Enterprises by Ralph C Jones and League of Nations" (1935) 30 *Journal of the American Statistical Association* 130 at 131.

centre of management.[68] He understood the term "undertaking" used in the League's drafts in the context of a corporate entity rather than as a mere reference to business activity.[69]

Furthermore, Carroll suggested three methods for allocating business profits in a hierarchical order. The first was the "separate accounting" method, in which businesses in different jurisdictions were treated as separate independent entities.[70] This method calculates separate accounts of each establishment based on the remuneration of services rendered to an enterprise or presumed sales between associated establishments at the prevailing market or arm's length value. However, the latter might lead to the assumption that income is derived when wealth is transferred to an outsider, instead of recognising the income at the time of rendering services.[71] The second "empirical" method was applied if a company's profits did not correspond to the profits of similar trade under the first method. This method determined taxable income as a percentage of the business turnover concerning similar enterprises operating in the State.[72] The last method was "fractional apportionment" in case both methods were inadequate, although, technically speaking, this method should be folded into the second method. In the ratio of certain factors, such as gross receipts, assets and the number of hours worked, the total profit would be divided.[73] The total profit for this purpose may be joint income produced by the entire enterprise or only the establishments conducting business in association with the local establishment.[74] This method was unpopular owing to the difficulty in obtaining and verifying overseas accounts, particularly when such accounts might be written in a different language or using a different currency.[75]

In the aforementioned methods, subsidiaries were treated distinctively from PEs.[76] Therefore, all definable legal entities treated as taxpaying entities and their PEs would be presumed to operate with each other at arm's length, particularly for the application of the first method.[77] Defining residence or fiscal domicile of corporate entities, Carroll noted, would allow various head office expenses incurred for the whole of an enterprise (eg, office administration costs, remunerations of directors, officers, accountants and technical experts and marketing and advertising costs) to be definitively allocatable to subsidiaries and local branches.[78]

68 Mitchell B Carroll, *Taxation of Foreign and National Enterprises – Volume IV* (League of Nations, 1933) at 169–170 (*Carroll's Report*). Carroll also said this was equivalent to the British standard of *central management and control* and generally, but not always, coincided with the concept of *statutory seat* adopted in Continental European countries.

69 At 34.

70 At 189–190. Carroll noted that "any enterprise of importance keeps accounts, often in accordance with the requirements of the commercial or fiscal law of the country" (at 48). He found that many countries had already adopted this method, including the United Kingdom, the Irish Free State, British India, South Africa, Belgium, France, Italy, the Netherlands, Germany and Danzig, Austria, Czechoslovakia, Hungary, Denmark, Sweden, Estonia, Latvia, Poland, Bulgaria, Greece, Roumania, Yugoslavia, Japan, Cuba, Mexico, the Federal Government in the United States (at 88). This method was claimed to be simple, just and flexible, according to Charles P White "Reviewed Work(s): Taxation of Foreign and National Enterprises by League of Nations" (1934) 176 *The Annals of the American Academy of Political and Social Science* 235.

71 *Carroll's Report*, above n 68, at 202.

72 At 190.

73 At 190–191.

74 At 46.

75 At 45 (noting that Spain and Switzerland adopted the third method as their primary method to determine territorial profits).

76 This was adopted and expressed in League of Nations, Draft Convention (1933) Protocol art 2(c). See also League of Nations, Revised Text of the Draft Convention (1935) Protocol art 2(c) (below n 81).

77 League of Nations, Draft Convention (1933) art 3. See also See also League of Nations, Revised Text of the Draft Convention (1935) Protocol art 2(c) (below n 81) art III(2).

78 *Carroll's Report*, above n 68, at 97.

The League of Nations saw that a multilateral agreement would be the way to go to realise fair allocation of business profits. However, few countries cared to enter a multilateral tax treaty.[79] In 1935, the League of Nations replaced the 1933 draft with a bilateral model containing the substantially same text as in the 1933 draft.[80] The 1933 definition of fiscal domicile of an enterprise remained.[81]

3.1.3 Continuing origin-domicile conflict: the 1940s until the dissolution

WWII significantly impeded the work of the League of Nations. In April 1940, member countries were at The Hague to discuss further harmonisation of the 1928 and 1935 drafts. However, this work was carried out by the countries that did not participate in the early part of the war. Significant in this event was that more developing countries became involved. Until that time, the League's drafts were predominately developed by developed countries, although there is a record that Chile made submissions regarding the 1927 draft.[82]

A regional meeting was held in Mexico, attended by representatives from Latin America, Canada and the United States, in 1943. This meeting resulted in the so-called "Mexico" draft,[83] named after the location of the meeting. After the war ended, in 1946, another meeting was held in London in the majority attendance of similarly developed European countries, which produced a separate "London" draft.[84] Whereas the Mexico draft envisaged source-based taxation, the London draft favoured developed countries. This was clear in the drafting of taxing jurisdictions of business profits.

In the Mexico draft, the fiscal domicile of an enterprise was defined as the place of incorporation,[85] which was common in American legal systems.[86] The definition of PE was central to the regularity and continuity of a business or activity, as opposed to the permanent place of business. Thus, income from such a business or activity was *only* taxable in the State of origin, whereas the State of domicile was allowed to tax if an enterprise extended its activities through isolated or occasional transactions.[87] This definition seems more relevant to the business practice of modern time, where a fixed physical location is becoming less significant for making business profits.

Conversely, the London draft specified that an enterprise had domicile in the place of its real centre of management,[88] consistent with that contained in many tax treaties entered between European countries.[89] In this draft, income of an enterprise was taxable in the State in which it had a PE, and if there was no PE, the income shall be taxable where an enterprise had its domicile.[90] There was no proviso that domicile taxation

79 Fiscal Committee *Report to the Council on the Fifth Session of the Committee*, League of Nations Doc C.252.M.124 (17 June 1935) at 2.
80 Above n 79, (containing League of Nations, Revised Text of the Draft Convention (1935)).
81 League of Nations, Revised Text of the Draft Convention (1935) Protocol art 2(b).
82 Skaar, above n 48, at 88.
83 League of Nations, Mexico Draft (1943) (contained in Fiscal Committee, London and Mexico Model Tax Conventions: Commentary and Text, League of Nations Doc. C88.M.88 (November 1946) (*League's Report 1946*).
84 League of Nations, London Draft (1946) (contained in Fiscal Committee, London and Mexico Model Tax Conventions: Commentary and Text, League of Nations Doc. C88.M.88 (November 1946).
85 League of Nations, Mexico Draft (1946) Protocol art II(4).
86 *League's Report 1946*, above n 83, at 11. See also Donald R Whittaker "An Examination of the OECD and UN Model Tax Treaties: History, Provisions and Application to US Foreign Policy" (1982) 8(1) *North Carolina Journal of International Law* 39 at 48–49 (stating that this test is mechanically more objective).
87 League of Nations, Mexico Draft (1943) art IV(1)–(2).
88 League of Nations, London Draft (1946) Protocol art II(4).
89 Above n 83, 11.
90 League of Nations, London Draft (1946) art IV.

was allowed in the case that an enterprise carried out isolated or occasional transactions. The real centres of management were not included in the definition of PE in both, but in head offices.[91]

Although the definition of PE in the Mexico and London drafts differed, the League of Nations made a somewhat misleading observation that, in its commentaries to those drafts, the PE articles had a general definition that (1) an enterprise must have a fixed place of business and (2) that place of business must have a productive character.[92] Along with the definitions of an enterprise and its fiscal domicile or residence, the principle requirement of a fixed place, other than the "agency PE", which could be established without a fixed place of business, was a significant contribution that the League of Nations made to tax treaty standards. This would be troublesome, however, with evolving business practice that makes a fixed physical location with permanence less significant for the derivation of income.

Nonetheless, the League of Nations noted that the essential difference between the London and Mexico models rested with the taxation of interest, dividends, royalties, annuities and pensions.[93] The difference in the taxation of interest, dividends and royalties is significant because intragroup transactions can relocate business profits to different jurisdictions.

The models were compared under the Mexico draft by lumping dividends and interest together under the heading "income from movable capital" to give exclusive taxation to the State in which capital was invested.[94] Under the London draft, dividends were taxable in the State of a legal entity's real centre of management (or fiscal domicile),[95] whereas the tax on interest income was shared between the State of fiscal domicile and the State in which interest income was earned (ie, origin).[96] For interest, the State of origin would either reduce tax liability or impose a withholding tax up to a certain percentage fixed by agreement, enabling the shifting of business profits to the State of fiscal domicile. Waiving the interest taxation at source was common for countries desiring capital investment from the United States.[97]

Royalties from owning or possessing real property were taxable in the State where the property was situated,[98] however, in the Mexico draft, royalties from scientific, industrial and commercial property

91 League of Nations, London Draft (1946) Protocol art V.

92 League of Nations, Mexico Draft, 14.

93 League of Nations, Mexico Draft ('Virtually, the only clauses where there is an effective divergence between the views of the 1943 Mexico meeting and those of the 1946 London meeting are those relating to the taxation of interest, dividends, royalties, annuities and pensions.'). Previously, income from the interest of transferrable securities, deposits and current accounts were deemed taxable in the State in which creditors had domicile, where the State of the debtor could tax on interest income untaxed in the State of the creditor. See, eg, League of Nations, Draft Model Treaty No. 1A (1928) arts 3–4.

94 League of Nations, Mexico Draft (1943) art IX.

95 League of Nations, Mexico Draft (1943) art VIII. It is achieved by (1) giving the taxation right to the State in which a legal entity covered in the convention had its domicile and (2) avoiding taxation in the State in which any subsidiary or associated entity had its domicile without and enterprise. The commentary to this Article states that undistributed profits were inclusive of dividends (p 25). This treatment is justified on the basis that some countries imposed a special tax on undistributed profits when the distribution of dividends did not reach a certain limit.

96 League of Nations, London Draft (1946) art IX.

97 Mitchell B Carroll "Evolution of US Treaties to Avoid Double Taxation of Income – Part II" (1969) 3(1) *International Lawyer* 129. For example, Sweden initially allowed full taxation in the State of the creditor in the Income-Tax Convention, with Accompanying Protocol, US-Sweden, signed 23 March 1939, TS958 (entered into force 1 January 1940). However, Canada reserved its right to tax at source up to 15 per cent in Income-Tax Convention, with Accompanying Protocol, United States-Canada, signed 4 March 1942, TS 983 (ratified 15 June 1942). The United Kingdom initially followed the footstep of Sweden to waive its taxing right at source in its treaty with the United States (Income-Tax Convention, United States-United Kingdom, signed 16 April 1945, TIAS 1546 (entered into force 1 January 1945)) provided the creditor was not engaged in a business or trade in the United Kingdom. In the subsequent Income-Tax Supplementary Protocol, United States-United Kingdom, signed 17 March 1966, TIAS 6089; 17 UST 1254 (ratified 9 September 1966), source taxation was allowed up to 15 per cent.

98 League of Nations, Mexico Draft (1943) art X(1); League of Nations, London Draft (1946) art X(1).

(eg, patents, secret processes, trademarks, trade names, etc) were taxable in the State where the right was exploited or used. Conversely, in the London draft, such royalties went to the State to which the grantor belonged unless the royalty transacted between related enterprises was taxable in the State in which the rights were exploited.[99] Consistent with treaty practice, in both drafts, copyright royalties were exempted from taxation in the State where they are exploited, in both drafts, and exclusively taxable in the State of residence.[100]

In the 1940s, treaty practice varied concerning the treatment of industrial or commercial royalties. A decade earlier, French authors complained about the United States taxation, leading to both countries concurring to the tax exemption of royalties at the source in a treaty established in 1932.[101] Notwithstanding the negotiation's origin, the exemption also applied to patents, secret processes, formulae, trademarks and similar rights.[102] Conversely, the 1942 Canada–United States treaty allowed the taxation of industrial or commercial royalties of up to 15 per cent at the source, given the royalties were not connected to a PE.[103] Furthermore, the 1945 United Kingdom–United States treaty waived source taxation, provided that the recipient had no PE, because the United Kingdom desired to utilise the United States technology for its domestic industries.[104]

Considering treaty practice, differences in the treatment of investment income were not merely a matter of different ideologies espoused by developed or developing countries. According to capital import and export strategies, the variances evolved from the treatment of business profits and whether the contracting State was a developing or developed nation.

3.2 OEEC

Two years after the League of Nations was dissolved, the OEEC was incepted in 1948 with 18 developed, relatively homogenous European countries.[105] The OEEC inherited the League's work drafting a tax treaty model, primarily drawing on the London draft style.[106] During the 13 years until dissolution in 1961, the OEEC produced four reports containing commentaries on the model tax treaty articles.

In its first report published, in 1958,[107] the OEEC made two notable innovations in dealing with PEs. First, the PE article began with a standard definition to the modern conventions that a PE means 'a fixed place of business in which the business of the enterprise is wholly or partly carried on' but does not require

99 League of Nations, Mexico Draft (1943) art X(2)–(3); League of Nations, London Draft (1946) art X(2)–(3).

100 League of Nations, Mexico Draft (1943) art X(4); League of Nations, London Draft (1946) art X(4).

101 Carroll, above n 97, at 142 (citing Income-Tax Convention, with Protocol, United States-France, signed 27 April 1932, TS 885 (entered into force 1 January 1936)).

102 Note this exemption was removed in the tax convention entered between France and the US on 28 July 1967, to allow the taxation at source up to 5 per cent of royalty income related to patents, secret processes, formulae, trademarks and similar rights.

103 Carroll, above n 97, at 141 (citing *Income-Tax Convention, with Accompanying Protocol*, US-Canada, singed 4 March 1942, TS 983 (ratified 15 June 1942) art 11).

104 Carroll, above n 97, at 142 (citing *Income-Tax Convention*, US-UK, singed 16 April 1945, TIAS 1546 (entered into force 1 January 1945) art VIII).

105 Original member countries were Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, United Kingdom, and Western Germany (originally represented by both the combined American and British occupation zones (The Bizone) and the French occupation zone). The Anglo-American zone of the Free Territory of Trieste was also a participant in the OEEC until it returned to Italian sovereignty.

106 According to Carroll, the London draft was an obvious choice as the OEEC comprised European countries. See Carroll, above n 43, at 708–709.

107 Fiscal Committee of the OEEC *The Elimination of Double Taxation* (September 1958).

that a PE's activity must be productive to contribute to business earnings.[108] The general definition was followed by inclusive and exclusive examples and dependent and independent agents. Second, the "agency PE" was described more concisely and in a principled manner. For instance, a dependent agent must have the authority to conclude contracts in the name of an enterprise and have exercised that authority.[109] An enterprise would have no PE if it conducted on business through a broker, general commission agent or an independent agent.[110]

The OEEC claimed that dividends, interest, and royalties had substantially the same character.[111] After consulting with member countries, they redrafted the related articles as follows. Dividends were taxable in the State of fiscal domicile, subject to limited taxation rights of the State of source: up to five per cent of the gross amount of dividends if the recipient was a company and had a direct shareholding of at least 25 per cent, or 15 per cent in all other cases.[112] The 1965 treaty between the Netherlands and the United States established this two-rate structure, wherein the general outbound dividend rate for portfolio investment was 15 per cent. Conversely, the dividends paid by a subsidiary based on the shareholding of at least 25 per cent, were taxable at five per cent at the source.[113] Similarly, interest was taxable in the creditor's domicile State, subject to the debtor's State having the taxation rights for up to 10 per cent of the gross amount of interest.[114] Royalties from scientific, industrial and commercial property and copyright royalties were also taxable in the State of fiscal domicile unless an enterprise exploited the property for which the royalty was paid by operating through a PE. In this case, the source country would tax the royalty, provided it did not exceed an arm's length price.[115]

3.3 OECD and UN

The OECD, formed in 1961, continued the work of its predecessor, OEEC, and produced a uniform model tax convention in 1963.[116] In the 1960s, the developed countries used this draft as a customary framework to negotiate bilateral tax treaties. According to Surrey, the OECD's model was grounded on two propositions: "(1) the country of residence will eliminate double taxation through a foreign tax credit mechanism or through exemption for foreign income from tax; (2) in turn, the country of source will considerably reduce both the scope of its jurisdiction to tax at source and the rates of tax where jurisdiction is retained".[117]

The UN established the United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries (the UN Group), comprising 10 experts from developing countries and eight experts from developed countries. These experts did not represent their countries but contributed to developing policy and technical guidelines for negotiating bilateral tax agreements on a non-biased basis. Developing countries did not participate in drafting of the OECD's model or consider the model fit for their fiscal

108 Above n 107, annex II (titled *Article on Permanent Establishment*). See para (1) of the Article.
109 Above n 107, annex II (titled *Article on Permanent Establishment*). See para (4) of the Article.
110 Above n 107, annex II (titled *Article on Permanent Establishment*). See para (5) of the Article.
111 Fiscal Committee of the OEEC, *The Elimination of Double Taxation: Fourth Report* (August 1961) at 14 (*OEEC's Fourth Report 1961*).
112 *OEEC's Fourth Report 1961*, annex A (titled *Article on Taxation of Dividends (Article XX)*).
113 Carroll, above n 97, at 136–137 (citing Income-Tax Supplementary Protocol, United States-Netherlands, signed 30 December 1965, TIAS 6051; 17 UST 896 (ratification exchanged 8 July 1966)).
114 *OEEC's Fourth Report 1961*, above n 111, annex B (titled *Article on the Taxation of Interest (Article XXI)*).
115 Above n 111, annex C (titled *Article on the Taxation of Royalties (Article XXII)*).
116 OECD, Model Tax Convention on Income and on Capital (1963).
117 Stanley S Surrey "United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries" (1978) 19(1) Harv Int Law J 1 at 8.

policies; several developing countries argued for exclusive source taxation. Accordingly, the UN Group did not presume the correctness of the principles espoused in the 1963 model.[118]

The UN Group held seven meetings, including one after the OECD revised its 1963 draft in 1977.[119] Its work led to the release of the first UN draft in 1980,[120] suggesting that the treaty policy in developing countries "(a) take into account expenses allocable to the earnings of the income so that such income would be taxed on a net basis; (b) not be so high as to discourage investment; and (c) take into account the appropriateness of a sharing of revenue with the country providing capital".[121]

The OECD and UN updated their model convention in the subsequent decades, focusing on interpreting the framework and articles' language. The BEPS project made considerable changes to the residence, PE, and investment income articles.

3.3.1 From fiscal domicile to residence

Several authors have argued that the term "fiscal domicile" was inappropriate because its meaning operates under the twin rule that a person must have one domicile and cannot be without a domicile, whereas residence can be in multiple locations at a given time.[122] Although it is uncertain whether this difference was acknowledged, the OECD and UN reworded "fiscal domicile" to "residence" in their respective first model convention.[123] According to the residence article of both conventions, an artificial entity shall be determined according to the laws of each contracting State. However, in the case of dual residence, a tiebreaker rule would assign residence as the place of effective management.

The tiebreaker rule lasted until 2017 when the draft from the OECD and the UN determined that the place of effective management was no longer the tiebreaker; tiebreaking would be determined by contracting parties through mutual agreement, having regard to any relevant factors such as the place of effective management and the place where the party is incorporated or otherwise constituted.[124]

The OECD stated that removing the tiebreaker rule was due to problems of dual residence.[125] However, having no coherent definition is more likely to exacerbate problems with dual residence rather than resolve them.[126] For example, enterprises located in a country where residence is the place of incorporation can avoid residence status by incorporating elsewhere. However, relocated enterprises can also avoid residence status

118 At 8.

119 Department of Economic & Social Affairs, *Tax Treaties Between Developed and Developing Countries: First Report*, UN Doc. ST/ECA/110 (1969); *Second Report*, UN Doc. ST/ECA/137 (1970); *Third Report*, UN Doc. ST/ECA/166 (1972); *Fourth Report*, UN Doc. ST/ECA/188 (1973); *Fifth Report*, UN Doc. ST/ESA/18 (1975); *Sixth Report*, UN Doc. ST/ESA/42 (1976); *Seventh Report*, UN Doc. ST/ESA.78 (1978).

120 UN, Model Double Taxation Convention between Developed and Developing Countries (1980).

121 Surrey, above n 117, at 9.

122 Erwin Spiro "Fiscal Domicile in the Law of Double Taxation Agreements" (1970) 3(1) *The Comparative and International Law Journal of Southern Africa* 80 at 82–83.

123 OECD, Model Tax Convention on Income and on Capital (1963) art 4; UN, Model Double Taxation Convention between Developed and Developing Countries (1980) art 4.

124 OECD, Model Tax Convention on Income and on Capital (1963) art 4(3); UN, Model Double Taxation Convention between Developed and Developing Countries (1980) art 4(3).

125 OECD, Model Tax Convention on Income and on Capital (December 2017) 112.

126 The OECD assumes that dual residence is mostly abusive, which Maisto et al claims to be incorrect because dual residence more commonly arises from the adoption of incorporation as a tax residence criterion or other commercial situations such as mergers, industry-specific business models (such as in funds management) and vertical management. See Guglielmo Maisto et al "Dual Residence of Companies under Tax Treaties" (2018) 1 *IBFD International Tax Studies* 3 at 43–44.

if the country to which they relocate assesses residence based on effective management.[127] Furthermore, enterprises would have residence somewhere if the corporate residence is consistently defined as effective management.

3.3.2 Permanent establishment

The OECD and UN models provide the same general definition that a PE means a fixed place through which an enterprise carries on its business.[128] However, there are notable differences in understanding what constitutes a sufficient contact to source countries. First, the UN model considers *delivery* as a significant contact to instigate taxation at the source. However, under the OECD model, the use of a facility solely for the delivery of goods and the maintenance of a stock of goods or merchandise belonging to the enterprise for deliveries do not constitute a PE. Second, the UN model states that an enterprise is liable to tax if it carries on services, including consultancy, through employees or other personnel once such activities have continued for at least half of the 12-month assessment period.[129] The OECD model does not include this stipulation. Third, the UN model expands the *force-of-attraction* principle, increasing source country taxation scope. Under the OECD model, a PE is taxed on its business profits. This is expanded in the UN model specifying that sales of goods, merchandise or other business activities can be taxed in the source country if they are of the same or similar kind as those affected *through* a permanent establishment.[130] Accordingly, the PE need not conduct such sales or activities.

It is generally accepted that PEs are taxed on their *net* income; therefore, revenue share is possible through intragroup transactions. The UN Group was concerned that developing countries might be unable to afford significant losses of their tax bases owning to revenue share.[131] This concern led to the inclusion of non-deductibility of interest, royalties and any payments for money lent or rights provided in the taxable profits of PE in the UN model.[132]

Some innovations have recently appeared in response to concerns that business operations are arbitrarily segmented through commissionaire arrangements or similar strategies to avoid taxation in the source country.[133] In 2017, the PE threshold was modified in the OECD and UN models, assigning PE

127 The notable tax planning structure is the so-called ‘double Irish Dutch sandwich’ structure used by United States-based enterprises. The structure and its modifications are explained in Edward D Kleinbard “Stateless Income” (2011) 11(9) Fla Tax Rev 699 at 707–714; Michael J Graetz and Rachael Doud “Technological Innovations, International Competition, and the Challenges of International Income Taxation” (2013) 113(2) Columbia Law Rev 347 at 399–440; Andrew Fischer “A Comprehensive Approach to Stateless Income” (2015) 83(3) George Wash Law Rev 1028 at 1037–1039; Kiyoshi Nakayama and Victoria Perry “Residence-Based Taxation: A History and Current Issues” in Ruud De Mooij, Alexander Klemm and Victoria Perry (eds) *Corporate Income Taxes under Pressure* (International Monetary Fund, February 2021) at 107. See also Apple’s corporate tax planning involving Irish incorporated companies managed in the US in Antony Ting “iTax — Apple’s International Tax Structure and the Double Non-Taxation Issue” (2014) 2014(1) BTR 40.

128 OECD, Model Tax Convention on Income and on Capital (2017) art 5(1); UN, Model Double Taxation Convention between Developed and Developing Countries (2017) art 5(1).

129 Article 3(b) of the United Nations, Model Double Taxation Convention between Developed and Developing Countries (New York: UN, 2017).

130 Compare UN, Model Double Taxation Convention between Developed and Developing Countries (2017) art 7(1) with OECD, Model Tax Convention on Income and on Capital (2017) art 7(1). See also the commentaries to the articles.

131 Surrey, above n 117.

132 See UN, Model Double Taxation Convention between Developed and Developing Countries (2017) art 7(3).

133 The related work is contained in OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report* (OECD Publishing, 2015).

status when business activities conducted for a cohesive business operation in the source country were not merely preparatory or auxiliary.[134]

3.3.3 Dividend, interest and royalty

The OECD provided tax rate ceilings for interest and dividends in the source country and exclusive taxation of royalties in the residence country.[135] However, the UN Group found that developing countries would be unlikely to accept the low level of taxation at the source because the investment flow between developed and developing countries is not reciprocal.[136] Accordingly, the UN draft, updated from time to time, departed from the OECD's taxation right allocation rules for investment income.[137]

It was challenging to prescribe a maximum tax rate allowed in the source country. Exclusive source taxation can be considered, but it would not be rational given that investors would incur costs for investment in their country. Conversely, if the source country's tax rate is too high, capital inflow could be impeded, distracting institutional investors or encouraging lenders to shift the tax burden to borrowers. Ultimately, the UN Group decided not to specify the tax rate ceilings and left them for the contracting States to negotiate.[138]

Similarly, the OECD model's tax rate ceilings of dividends are not left unspecified in the UN model.[139] While developing countries' primary concern regarding dividends is direct investment, the UN took a flexible approach to dividends related to business profits and portfolio dividends.[140] The shareholding percentage of 25 per cent, which determines direct or indirect investment in the OECD model, was reduced to 10 per cent in the 1980 model because some developing countries capped non-residents' maximum shareholding at 50 per cent.[141] This measure was replaced with 25 per cent in 2017, which was considered more appropriate.[142]

4.0 OECD/G20 BEPS PROJECT

In the wake of the global financial crisis, in 2009, G20 countries asked the OECD to take action to deal with revenue losses. While the work aimed to address tax gaps, loopholes, conflict and mismatching, many raised significant concerns that multinational enterprises were reducing their global tax liability through treaty shopping and exploiting different national tax rules.[143] The OECD was considered most fit for tackling

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134 OECD, Model Tax Convention on Income and on Capital (2017) art 4(1); UN, Model Double Taxation Convention between Developed and Developing Countries (2017) art 4(1).

135 OECD, Model Tax Convention on Income and on Capital (1963) arts 10 (dividend), 11 (interest), 12 (royalty). The wording in those Articles were almost identical in arts 10, 11 and 12 of OECD, Model Tax Convention on Income and on Capital (OECD, Paris, 2017).

136 Surrey, above n 117.

137 UN, Model Double Taxation Convention between Developed and Developing Countries (1980) arts 10 (dividend), 11 (interest), 12 (royalty).

138 Articles 11, 12. See also UN, Model Double Taxation Convention between Developed and Developing Countries (2017) arts 11, 12. The UN suggested the tax rate ceilings be determined with consideration of the interest on deferred payments or credit sales in addition to ordinary lending without involving goods of trade. See UN, Model Double Taxation Convention between Developed and Developing Countries (1980) art 11 commentary.

139 UN, Model Double Taxation Convention between Developed and Developing Countries (1980) art 10; UN, Model Double Taxation Convention between Developed and Developing Countries (2017) art 10.

140 Surrey, above n 117.

141 UN, Model Double Taxation Convention between Developed and Developing Countries (1980) art 10(2).

142 UN, Model Double Taxation Convention between Developed and Developing Countries (2017) art 10(2), p 259 (art 10 commentary).

143 *OECD Action Plan*, above n 3, at 13. See also Michael P Devereux and John Vella "Are We Heading Towards a Corporate Tax System Fit for the 21st Century?" (2014) 35(4) Fisc Stud 449.

global tax minimisation or avoidance, presumably owing to its historical credentials of developing model tax conventions and addressing multilateral restructurings of international monetary and trade relationships since the end of WWII.[144]

In 2013, the OECD launched the BEPS project and delivered the project reports (the Final Reports) two years later, on 5 October 2015.[145] The introduction of the MLI and IF soon followed the release of the Final Reports. These two initiatives were intended to implement various recommendations submitted in the Final Reports, indicating a renewed interest in the single tax principle[146] that posits that income should be taxed only once – no more and no less. The League of Nations had elaborated on this principle in its 1927 report,[147] and its application can be found in the United States treaty practice that includes the "subject to tax" clauses to deny treaty benefits in dealing with certain tax havens from as early as the 1960s.[148] Although the principle is not new, interest was renewed in the 1990s, promoted by the internationally renowned scholar, Avi-Yonah, along with the benefit principle suggesting that business income should be taxed according to its source.[149] The following provides examples of how the BEPS project similarly promotes the single tax principle in the MLI and the IF.

4.1 Multilateral Instrument

Like the multilateral models drafted by the League of Nations, the MLI (delivered in November 2016) recognised that bilateral conventions would be only a partial solution to the problem of double taxation. However, the OECD's MLI was drafted to bypass renegotiation of the extensive network of bilateral tax treaties of over 3,000 signatories specifying which of their tax treaties would be covered by which MIL articles, giving effect to overriding existing treaties.[150] Doing so enabled the OECD to envision that, apart from eliminating double taxation, opportunities for non-taxation or reduced taxation through tax evasion or avoidance would be lessened.[151] In particular, three following examples, optional to adopt, show the embedment of the single tax principle.

The first example is hybrid mismatch rules, preventing taxpayers from claiming treaty benefits using different cross-national tax laws. Three aspects were of particular interest. First, transparent entities were recognised, and their income was specified as a resident's income (eg, a resident partner in a partnership);

144 Although the European Union also took part of current tax issues, its involvement has been limited to a few directives of intercompany payment of dividends, interest and royalties, and tax-driven mergers.

145 The OECD released the final BEPS package of 15 action plans for reform of the international tax system. The executive summary can be found in OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Executive Summaries: 2015 Final Reports* (OECD Publishing, 2015). The reports are available on <www.oecd.org/ctp/beps-2015-final-reports.htm>.

146 The single tax principle embedded in the BEPS project is mentioned in Ruth Mason "The Transformation of International Tax" (2020) 114 AJIL 353; Leopoldo Parada "Full Taxation: The Single Tax Emperor's New Clothes" (2021) 24(2) Fla Tax Rev 729.

147 Hugh J Ault "Some Reflections on the OECD and the Sources of International Tax Principles" (2013) 70 *Tax Notes International* 1196 (citing *League's Report 2017*).

148 Reuven S Avi-Yonah "International Taxation of Electronic Commerce" (1997) 52(3) Tax Law Rev 507. See also Reuven S Avi-Yonah and Gianluca Mazzoni, *Stanley Surrey, The 1981 US Model, and the Single Tax Principle* (University of Michigan Law School, Law & Economics Working Paper, 31 March 2021) (citing US tax treaties entered in the 1960s); Reuven S Avi-Yonah "Who Invented the Single Tax Principle?: An Essay on the History of U.S. Treaty Policy" (2014/15) 59 NYLS Law Review 305.

149 Reuven S Avi-Yonah 'International Tax as International Law: An Analysis of the International Tax Regime' (Cambridge University Press, 2007).

150 OECD, Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (OECD Publishing, 2016) at [4].

151 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 6(1).

hence, no treaty benefits were available for income not subject to tax in the contracting jurisdiction.[152] Second, the definition of corporate residence was left to the contracting jurisdictions to reflect the changes to the model text in the same manner that the OECD/UN bilateral model tax conventions recommended.[153] Third, limitations were imposed on methods to eliminate double taxation to avoid any treaty benefit arising from a mismatch. An additional exemption method was introduced to negate treaty benefits so tax-deductible dividends would be taxed in the recipient's State.[154]

The second example is a minimum shareholding period of 365 days to limit opportunistic access, reduce taxation in the source jurisdiction, and foster genuine long-term investment.[155] Similarly, once over 50 per cent of the value was directly or indirectly sourced from real property, a minimum interest holding period of 365 days was inserted to tax capital gains in the jurisdiction where the real property was situated.[156] Both rules held that a holding period of less than 365 days was presumed to receive treaty benefits. Treaty benefits were also denied in the home jurisdiction when an enterprise derived income through a permanent establishment located in a third jurisdiction, and that income was less than 60 per cent of the tax that would otherwise be levied in the home jurisdiction.[157] This condition also assumes that a permanent establishment in the third country was intended to receive treaty benefits based solely on the low-tax rate. The modifications were designed to provide certainty while ensuring single taxation.

The last example is the changes to the permanent establishment status. The potential for artificial avoidance of permanent establishment status through commissionaire arrangements or similar strategies[158] or splitting up contracts[159] was eliminated by establishing permanent establishments of a cohesive business operation if complementary functions could be provided in the source country.

4.2 Inclusive Framework

The IF was introduced in January 2020 as an extension of the BEPS project's first action items, which concerned taxation in the digital economy. The impact of digitalisation is not limited to a particular type of economy but has an overall effect on the economy by remoteness and the capacity to conduct business with minimal personnel. Traditional claims to tax based on physical presence could be bypassed to shift profits to low- or no-tax jurisdiction through the transfer of valuable intangible assets or high-risk contractual arrangements.[160] Accordingly, new taxing bases to capture untaxed profits were introduced with two-pillar solutions.

152 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 3.

153 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 4.

154 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 5.

155 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 8.

156 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 9.

157 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 10.

158 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 12. See also the specific activity exemption options in art 13.

159 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 24 November 2016, art 14.

160 See Alessandro Turina "Which 'Source Taxation' for the Digital Economy?" (2018) 46(6–7) *Intertax* 495 (discussing tax policy surrounding the digital economy).

The first pillar deals with allocating taxation rights based on the destination of wealth.[161] It assumes that market jurisdictions contribute to generating business profits beyond the mere provision of an environment that enables sales;[162] value is assumed to be created in the market jurisdiction in the digital economy.[163] However, the scope of application of the solutions is limited to large multinational enterprises ("in-scope businesses"), with a global turnover above EUR 20 billion and profitability above 10 per cent. If in-scope businesses derive revenue of at least EUR 1 million in a jurisdiction, that jurisdiction would be allowed to impose an extra tax on 25 per cent of residual profit – that is, the profit representing the excess over 10 per cent of revenue allocable based on an agreed allocation key. The EUR 1 million threshold is reduced to EUR 250,000 for the jurisdictional revenue test during negotiation, where the lower threshold applies to jurisdictions with a GDP under EUR 40 billion. It is expected that, by 2022, a simplified and streamlined approach to the arm's length principle will apply to marketing and distribution activities will be formulated, with a particular focus on developing and emerging economies.

The second pillar, otherwise referred to as the Global Anti-Base Erosion (GloBE) proposal, addresses harmful "race-to-bottom" tax competition between jurisdictions.[164] It sets a global tax rate of 15 per cent, agreed upon in October 2021, for multinational enterprises with a global consolidated annual revenue of EUR 750 million, as determined by country-by-country reporting.[165] The top-up tax operates by four rules: (1) income inclusion rule (IIR), (2) undertaxed payment rule (UTPR), (3) subject to tax rule (STR) and (4) switch-over rule.[166]

Like the foreign-controlled company regime, the IIR attracts income to the parent company as determined by ownership, subject to a spilled-ownership rule where shareholding is less than 80 per cent. It involves a series of complex calculations, such as identifying relevant constituents within the group, calculating each constituent's income and working out the top-up tax. If the IIR does not apply, the UTPR operates as a backdrop rule to adjust subsidiary's jurisdiction by either denying expenses paid to a group member or adjusting low-tax income. As a temporary measure, multinational enterprises operating in no more than five other jurisdictions and having a maximum of EUR 50 million in tangible assets abroad are excluded from the UTPR for five years. The IIR and the UTPR are optional interlocking domestic rules, with the IIR always applying before the UTPR.

The STR complements the UTPR and applies before the IIR operation to amend treaty provisions at the request of a developing country. It charges tax at source through withholding or other taxes on certain payments (eg, royalties) between related parties that cannot meet an agreed minimum tax rate, which currently nine per cent at the minimum. On the one hand, if the nominal tax rate on the royalty

161 This was accepted in October 2021, with 136 member jurisdictions reaching an agreement to apply a formula for destination taxation. See OECD *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD Publishing, October 2021) (*OECD Two-Pillar Solution 2021*).

162 See the proposed recommendations contained in OECD, *OECD/G20 Tax Challenges Arising from Digitalisation – Report on the Pillar One Blueprint* (OECD Publishing, October 2020).

163 *OECD Action Plan*, above n 3. Some authors argue that value creation is a departure from traditional norms whereas others argue to the contrary. See Stanley I Langbein and Max R Fuss "The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the Arm's Length Standard" (2018) 51(2) *International Lawyer* 259 at 262.

164 See OECD *OECD/G20, Tax Challenges Arising from Digitalisation – Report on the Pillar Two Blueprint* (OECD Publishing, October 2020). The tax rate refers to an effective tax rate calculated as the covered taxes divided by accounting profits.

165 See further the summary of Pillar 2 in Renee Leung "Global Minim Tax? A Rundown of Pillar Two Model Rules" Wolters Kluwer (online, 2 February 2022) <www.wolterskluwer.com/en-au/expert-insights/global-minimum-tax-pillar-two-model-rules>. See also the details of country-by-country reporting in OECD *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13: 2015 Final Report* (OECD Publishing, 2015).

166 *OECD Two-Pillar Solution 2021*, above n 161.

is five per cent in the recipient's jurisdiction, the payer's jurisdiction may impose a top-up tax rate of four per cent. However, when branch profits are not adequately taxed, the top-up tax under the switch-over rule overturns treaty obligations by changing from the exemption to the credit method of relieving double taxation.

Since the OECD released the Commentary to the Pillar Two Model Rules in March 2022, public consultation is expected next. The aforementioned discussion illustrates that setting a lower revenue threshold to apply the IIR would not undermine the spirit of the GloBE rules, whereas it would undermine the application of the UTPR.[167] However, the ultimate right to the top-up tax may be based on the place of incorporation. At this stage, no other international organisation provides a root-and-branch evaluation of the OECD's proposals as the UN had done to the OECD's model tax conventions. Instead, the OECD has involved 141 countries and jurisdictions in the IF process and calls its proposals "consensus-based".[168]

5.0 CONCLUSION AND RECOMMENDATIONS

Since four economists set out the principled base for assigning jurisdictional taxing rights in the early 1920s, there has been an ongoing effort to coordinate national taxations at the international level. The first nine decades saw the development and modification of model tax conventions with growing commentaries to the articles. While this work primarily focused on eliminating or preventing double taxation through treaty negotiation, a renewed interest in the single principle arose in 2013 when the OECD launched the BEPS project.

The twin problem of double taxation and non-taxation is challenging to resolve without standardising cross-national tax laws.[169] Tax competition is unavoidable in environments where an extensive network of treaties provides double taxation relief, which increases the incentive to treaty shopping and the exploitation of differences in national tax laws to minimise the global tax liability.[170] In countering profit shifting, tax loopholes and aggressive tax planning, there seems no clear way forward to tax a profit once and for all, given tax laws and the interpretation of tax terminologies are incoherent between jurisdictions.

Where there is no requirement under international law to remove double taxation, removing double non-taxation is not required, either. Parada noted that the single tax principle is conceptually inconsistent, albeit rhetorically attractive, because it does not have the reference baseline (such as the tax base and rate) to determine "all of a company's income should be taxed".[171] He disapproved the idea that international taxation is customary law, which Avi-Yonah posited, because the GloBE rule has not obtained the status of general practice, and there seems no conviction that deviating from the rule would raise some form of sanction.[172]

167 OECD *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)* (OECD Publishing, 14 March 2022).

168 See OECD *Understanding Tax Avoidance* (Webpage, 16 November 2021) <www.oecd.org/tax/beps/>.

169 Genschel and Rixen, above n 1, at 157.

170 Certainty of tax implications, such as a withholding tax of 10 per cent, inexorably leads to complex forms of treaty shopping. See, eg, Jones, above n 36, at 4 ("a state might have a 30% withholding tax on dividends. This certainly leads down a path to other states wanting treaties, but it does not stop there. Treaties lead inexorably to treaty shopping, and that leads to limitation of benefit articles in ever more complex forms. I am not alone in wondering if the cure is not to tackle the withholding tax in the first place"). Further, Shaheen said that "the substantive purpose of treaties [is] the facilitation of the nonuniform allocation of taxation rights with respect to taxes on income" because, without treaties, countries can in fact unilaterally provide double taxation relief. See Fadi Shaheen "Income Tax Treaty Aspects of Non-income Taxes: The Importance of Residence" (2018) 71(3) Tax Law Rev 583 at 585–586.

171 Parada, above n 146, at 747.

172 At 778–779.

Parada's argument is compelling. However, ignoring current concerns raised in the international taxation sphere is perhaps unrealistic. History has shown that model tax conventions were developed through negotiations, sometimes based on principles and, at other times, politics. Developing what might resemble single taxation, instead of simply rejecting it, is not an incorrect posture. The single tax principle can be just as ideal a pursuit as the meaning of "income" in income taxation. For this, international taxation can be improved. First, international taxation can be simpler, in terms of quantity and theory,[173] thereby decreasing mismatches and loopholes and creating fewer unintended tax planning opportunities. The second is to consider inter-nation neutrality. Although several countries are currently involved in the IF progress, the truth of consensus cannot be presumed, especially when all countries do not have sufficient resources to properly evaluate rapidly developing proposals and consider their own economy and tax environments.

Notably, the current scope of Pillar 1 is narrow, potentially because the IF was originated from dissatisfaction of developed countries with their inability to tax tech giants effectively. However, there is no reason for destination taxation being applied only to large enterprises and the jurisdictions in which they derive significant revenue. Conversely, under Pillar 2, developing countries have taxing rights as they can tax as much or little as they like; however, if they impose too little tax, the enterprise's home country can impose a top-up tax, implying that developing countries are limited in exercising their tax sovereignty (or use taxation as a means of their economic policy). The narrow scope of Pillar 1 and the likelihood of the top-up tax being directed at developed countries under Pillar 2 are examples that raise doubt regarding whether consensus-based solutions are really based on consensus and the long-term efficacy of their solutions, as the OECD claims.

From a conceptual standpoint, complexity in the residence-source conflict and single taxation arose from the arbitrary concept of an enterprise's residence.[174] In particular, segmentation of one coherent business operation has been troublesome as it unintentionally creates tax planning opportunities through artificial avoidance of PEs and intragroup interest or royalty transactions. There is no particular theoretical rationale for identifying economic connections to assign jurisdictional taxation rights based on an enterprise's fiscal domicile or residence. This is because enterprises do not consume like natural persons but instead distribute or reinvest their earnings; thus, the taxing rights given to residence jurisdictions can be removed.

Alternatively, an enterprise may be considered an entire group of associated entities. Although this does not completely remove some tax planning opportunities, it is nevertheless significantly simpler to visualise any contrived structure of the group. Any parts of the enterprise within the same jurisdictions can then be regarded as a single taxpayer to escape the artificial segmentation of activities in order to avoid permanent establishment status or the distribution of assets or risks to manipulate intragroup transactions. This approach echoes the force of attraction rule in the UN model tax convention.

Attribution of profits can be based on the benefit principle. Avi-Yonah suggested that single taxation is commensurate with the benefit theory in international taxation.[175] Other scholars have favoured source-based

173 See Michael P Devereux and John Vella "Implications of Digitalization for International Corporate Tax Reform" 46(6–7) *Intertax* 550 (suggesting that the existing international tax regime is built on arbitrary distinctions between residence and source and between different types of income).

174 Rosenbloom said that the reason for entering a treaty from the perspective of the residence country is dubious insofar as the present strategies for removing double taxation are considered. See H David Rosenbloom "The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System'" (2000) 53(2) Tax Law Rev 137 (concerning validity of an international tax regime and genuine political interest of individual jurisdictions).

175 Avi-Yonah 'International Taxation of Electronic Commerce', above n 148.

taxation, including Hines, who found that territorial taxation improves economic productivity.[176] In residence jurisdictions, the current taxing right must be removed to operate exclusive source taxation. Taxing rights can be given to a country with effective management because, as noted, taxation based on effective management is conceptually source taxation. However, taxing rights simply owing to incorporation will be lost. The draft rules of Pillar 2 effectively assign the place of incorporation, which may create a spate of corporate inversions to non-participating countries, contradicting the aim to combat base erosion and profit shifting.

Concerns may be raised about deductible payments on invested capital, such as interest, royalties or intragroup management or service fees. In jurisdictions where business income is derived, exclusive taxation is not just because costs are incurred with investments or providing services. Limitations may be imposed to allow deductions only up to a reasonable rate by referencing; for example, the amount of the transaction through a third party.

To further allocate the remaining profits after paying interest, royalties or intragroup service fees, it is useful to revisit the doctrine of economic allegiance, which initially included four elements: residence, which is irrelevant for our purpose; origin; the location of the wealth; and enforceability of the rights to the wealth. The narrow interpretation of origin sought physical manifestations of an economic presence to tax business profits (eg, servers and websites in e-commerce). Even if origin might be a critical factor of production, two other aspects have been recognised as essential elements for producing income. The location of the wealth was used to establish jurisdictional taxation rights in destination-based taxation, whereas the location of enforceable rights is relevant to the digital economy. Thus, it is reasonable to incorporate a broader concept of economic allegiance to suggest sharing taxation rights between origin and destination. However, the extent to which the profits shall be attributable cannot be precisely determined. As a matter of practice, a percentage may be assigned to give taxation rights to the State of destination, with the remainder distributable among the States of origin. The distribution based on origin cannot be determined on a principled basis. Instead, some practical method shall be adopted.

In devising practical profit allocation methods, the arm's length basis may be re-evaluated to ensure the full catchment of business profits. For example, while profits result from efficiently utilising valuable tangible or intangible capital, know-how or goodwill may not be visibly apparent. In the past, Carroll recommended empirical methods, such as fractional apportionment,[177] which may be revisited to formulate the allocation key to apportion profits between the States of origin and the destination State.

The suggestions set out above are in no way comprehensive but provide fundamental propositions for more straightforward and neutral international taxation. They illustrate the need for critical evaluation of the BEPS proposals from a conceptual standpoint to forecast the longevity of the international tax debate.

176 See James Hines "Territorial System is the Right Option Even if It's Hard to Accomplish" *American Enterprise Institute* (online, 28 September 2012) <www.youtube.com/watch?v=mZm2xkgocC8>. See also the support of territorial systems in Omri Y Marian, "Jurisdiction to Tax Corporations" (2013) 54(4) *Boston College Law Review* 1613 at 1630; John T VanDenburgh "Closing International Loopholes: Changing the Corporate Tax Base to Effectively Combat Tax Avoidance" (2012) 47(2) *Valparaiso University Law Review* 313 at 333–344.

177 See, eg, formulary apportionment popularly suggested for e-commerce in Subhajit Basu "International Direct Taxation and E-Commerce: A Catalyst for Reform" (2017) 10(1) NUJS Law Rev 19; Debora de Souza Correa Talutto "The Future of Profit Splits" (2019) 22(3) Fla Tax Rev 724.

It is impossible to eliminate all interpretative issues of income categorisation in the schedular system of current international tax regimes.[178] However, we can be hopeful that the dual problem of double taxation and non-taxation can be lessened.

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178 For example, payments for software or services in one jurisdiction may be treated as royalties in another; interest may be classified as dividends. See Jones, above n 36, at 17 ("There is no practicable way of distinguishing between different types of income under an income tax. … there is no answer to this problem if we continue with tax treaties in the current form").