1

Introduction

> [The treaty] is an auspicious indication of international comity and concert in a field of action that has been too long neglected. It deserves to be signalized as affording an example worthy of imitation in its essential principles, if not in all of its details, by other states.[1]

> The game plan is to be positive but hope as little as possible happens.[2]

I Introduction

The international tax treaty regime is entering the next stage in its evolution as governments seek to modify the OECD Model Tax Convention on Income and on Capital ('OECD Model') to address twenty-first-century concerns.[3] The two quotes suggest that the latest reforms may not be quite as enthusiastically received as the conclusion of the first international treaty addressing double income taxation.[4] This is perhaps unsurprising when the motivations for each are considered. At the turn of the twentieth century, the Austro-Hungarian Empire and Prussia were motivated to conclude a double tax agreement (DTA), as double taxation was considered an unfair burden which particularly affected residents of border areas, and was restricting cross-border activity.[5] Today, governments are concerned that multinational companies are minimising tax

[1] A. C. Miller, 'Fiscal Reciprocity' (1902) 10 *Journal of Political Economy* 255 at 255.
[2] Paul Oosterhuis (tax partner at Skadden Arps) quoted in John Gapper, 'Defensive Play in the World Cup of Corporate Taxation', *Financial Times*, 27 June 2014.
[3] OECD, *Model Tax Convention on Income and on Capital 2014: Full Version* (2015).
[4] The first international treaty expressly concerned with the prevention of double income taxation was concluded between the Austro-Hungarian Empire and Prussia (Germany) on 21 June 1899: United Nations, *International Tax Agreements*, vol. III: *World Guide to International Tax Agreements 1843–1951* (1951), p. 343.
[5] Sunita Jogarajan, 'Prelude to the International Tax Treaty Network: 1815–1914 Early Tax Treaties and the Conditions for Action' (2011) 31 *Oxford Journal of Legal Studies* 679 at 690–1.

liabilities through 'base erosion and profit shifting' (commonly referred to by the now ubiquitous acronym 'BEPS'). The BEPS Action Plan sets out fifteen action items including modifying DTAs to address the challenges of the digital economy, preventing treaty benefits in inappropriate circumstances, and preventing the artificial avoidance of permanent establishment (PE) status.[6] To the casual observer, it may seem somewhat surprising that, more than a century apart, such vastly different problems are being addressed by the same instrument. However, the story of DTAs is one of precedents, and a continuous narrative can be traced from the very first treaty in 1899 to the more than 3,000 DTAs currently in existence.[7]

The 1899 Treaty addressed double taxation by allocating taxing rights to the domicile-country in the case of personal income taxes, and to the source-country in the case of property and business income taxes. Utilising a concept now commonplace in all DTAs, Article 2 of the Treaty allocated the right to tax business profits to the country where a PE was located. The 1899 Treaty was followed by similar treaties between the Austro-Hungarian Empire and Liechtenstein (1901), Saxony (1903), Bavaria (1903), Würtemberg (1905), Baden (1908), and Hesse (1912). In addition, Luxembourg concluded treaties with Prussia (1909) and Hesse (1913), as did the Canton of Basle-Town (Switzerland) with Prussia (1910–11). These were the only international DTAs concluded prior to the Great War and, as they were concluded between contiguous states, were considered 'not of a character that would serve as the foundation for general international action'.[8] Further, it was thought that these early DTAs were predicated upon the similarity of the parties' tax systems and therefore did not have broader international application.[9] The background to these early DTAs and the impetus for action has been detailed elsewhere.[10] It is clear that the close political ties and interrelated history of the contracting parties were important factors behind the

6 OECD, *OECD/G20 Base Erosion and Profit Shifting Project: 2015 Final Reports – Executive Summaries* (2015), pp. 5, 21–3.
7 Jogarajan, 'Prelude to the International Tax Treaty Network', 681–4, 705–7.
8 Cornelius Gregg, 'Double Taxation' (1947) 33 (Problems of Public and Private International Law) *Transactions of the Grotius Society* 77 at 78. Sir Cornelius Gregg was the president of the UK Board of Inland Revenue.
9 John Herndon, *Relief from International Income Taxation: The Development of International Reciprocity for the Prevention of Double Income Taxation* (Callaghan and Company, 1932), p. 16.
10 Jogarajan, 'Prelude to the International Tax Treaty Network', 681–92.

conclusion of DTAs between these countries. Nonetheless, these pre-WWI DTAs did in fact establish some of the fundamentals of modern-day DTAs, such as the principle of reciprocity and one method of relieving double taxation (i.e. the allocation of taxing rights for different types of income based on either the source of the income or the residence of the taxpayer).

The end of the Great War sparked renewed interest in the conclusion of DTAs, as increases in taxation due to the war exacerbated the burden of double taxation.[11] Several treaties were concluded in the early 1920s, including the first multilateral tax treaty (Rome Convention).[12] However, the unfair burden of double taxation was not the only issue; double taxation was also thought to limit the international mobility of capital, thereby hampering post-war reconstruction efforts. Against this backdrop, the League of Nations entered the field of international taxation. Under the League's leadership, four reports on international double taxation were produced in the 1920s: the Economists' Report,[13] the 1925 Report,[14] the 1927 Report,[15] and the 1928 Report.[16] The 1928 Report included the first model treaties on double income taxation – the 1928 Models are considered one of the few successes of the League's work in commercial policy during the interwar period as more than a

[11] Herndon, *Relief from International Income Taxation*, 7. The United States and France increased their top income tax rates to more than 70 percent after the Great War, while the top rates in Germany and Britain were 40 and 60 percent, respectively: Richard Carr and Bradley Hart, *The Global 1920s: Politics, Economics and Society* (Routledge, 2016), p. 53.

[12] Convention for the Purpose of Avoiding Double Taxation between Austria, Hungary, Italy, Poland, Roumania and the Kingdom of the Serbs, Croats and Slovenes, Rome, concluded 6 April 1922, reproduced in League of Nations, *Double Taxation and Fiscal Evasion: Collection of International Agreements and International Legal Provisions for the Prevention of Double Taxation and Fiscal Evasion* (1928), pp. 73–5. The 1925 Report (below n. 14) states that the Rome Convention was signed on 13 June 1921, but the date recorded in the official collection is 6 April 1922. The Convention was only ever in force between Austria and Italy. Hereafter referred to as the 'Rome Convention'.

[13] G. W. J. Bruins et al., *Report on Double Taxation: Submitted to the Financial Committee* (League of Nations, 1923) ('Economists' Report').

[14] Technical Experts to the Financial Committee of the League of Nations, *Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations* (1925) ('1925 Report').

[15] League of Nations, *Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion* (1927) ('1927 Report').

[16] League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion* (1928) ('1928 Report').

hundred DTAs based largely on the 1928 Models were concluded between 1929 and 1939.[17] This second phase in the advancement of the international tax treaty regime – namely, the League's work culminating in the publication of the 1928 Models – is the focus of this book.[18]

II Structure of the Book

This book has eight chapters. The next chapter has three parts. The first part introduces the reader to the concept of international double taxation and explains how it arises. The first part also provides a brief overview of the various theories of taxation which were influential at the time and informed the Experts' discussions. The second part discusses the economic and political conditions of the 1920s to place the book in context. The third part of the chapter provides a brief overview of the formation of the League and its structure. It then explains how the League came to be involved in the effort to address international double taxation.

The League's work leading up to the publication of the 1928 Models falls naturally into three time periods, and the book adopts a chronological approach to examining the work leading up to the publication of the 1928 Models. Within each time period, the issues are examined thematically. The three chapters examining the three time periods form the substance of the book.

Chapter 3 examines the first of these time periods, 1923–5, which resulted in the publication by the League of Nations of the 1925 Report.[19] The 1925 Report was drafted by seven Experts and presented a series of resolutions on addressing double income taxation and fiscal domicile. As will be seen in Chapters 5 and 7, these resolutions provided the basis for the League's later work which resulted in the 1928 Models. Chapter 3 explains the principles that guided the League's Experts during their

[17] Alexander Loveday, 'The Economic and Financial Activities of the League' (1938) 17 *International Affairs* 788 at 790; Arthur Sweetser, 'The Non-Political Achievements of the League' (1940) 19 *Foreign Affairs* 179 at 183; League of Nations, *Commercial Policy in the Interwar Period: International Proposals and National Policies* (1942), p. 30; 'Part 2: The Progressive Development of International Law by the League of Nations' (1947) 41 (4)(Suppl.) *American Journal of International Law* 49 at 55. However, Spitaler argues that the 1928 Models were of limited use and the early German treaties were more influential: Armin Spitaler, *Das Doppelbesteuerungs-problem: Bei Den Direckten Steuern* (Gebruder Stiepel GES MBH, 1936), pp. 32–46.

[18] A timeline of the League's involvement in double taxation until the publication of the 1928 Models is included in Appendix 1.

[19] 1925 Report.

discussions, demonstrates that certain assumptions or conclusions which have been made about the work are erroneous, and provides insights into concepts that continue to be employed in modern DTAs and are the subject of ongoing discussions. For example, the BEPS action measures involve modifications to the PE concept. Chapter 3 reveals the original theoretical basis for the concept.

Chapter 5 examines the second time period, 1926–7, and details the drafting of the 1927 Report.[20] The 1927 Report included a first draft of a model DTA on double taxation. The 1927 Report was drafted by the original seven Experts who drafted the 1925 Report, and also included Experts from an additional six countries. Chapter 5 shows that the new Experts felt bound by the resolutions in the 1925 Report, as they were not privy to the earlier discussions and respected the fact that their colleagues had reached their conclusions unanimously following extensive deliberations. Much of the 1926 and 1927 sessions rehashed the earlier discussions, and the text of the model treaty was developed in a short time frame.

Chapter 7 discusses the drafting of the three model treaties on double income taxation published by the League in 1928.[21] The 1928 Models were the result of a single conference of representatives from twenty-seven countries held from 22 to 31 October 1928. From the outset, the delegates at the 1928 Meeting were tasked with achieving practical results in the form of useful model treaties and were advised that the time for theoretical discussion had passed. The 1928 Meeting again rehashed many of the discussions that had taken place previously and was largely focused on finalising the 1927 model treaty, which distinguished between personal and impersonal taxes. It was only towards the end of the Meeting that the Experts turned their attention to the development of two alternative conventions which did not distinguish between the two types of taxes. The 1928 Meeting also finalised the commentary accompanying the 1928 Models. Due to the practical nature of their work, the 1928 Experts were largely wedded to the original resolutions in the 1925 Report.

In between the three major chapters are two chapters that examine the influence of various parties on the League's work. Chapter 4 explores the influence of the International Chamber of Commerce (ICC) on the development of the 1928 Models. The ICC has often been attributed with having had a key role in the early work to address international double taxation, but this view is not supported by the research. The ICC was

[20] 1927 Report.
[21] 1928 Report.

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only involved in the League's work after the publication of the 1925 Report, thereby limiting its influence on the development of the 1928 Models, which were heavily based on the resolutions in the 1925 Report. However, the ICC's support of the League's work was no doubt instrumental in the League's proposals gaining broader acceptance. Chapter 6 explores the influence of the two 'great powers', Britain and the United States, on the development of the 1928 Models. It has been said that the United States significantly influenced the development of the 1928 Models, but that does not seem to be the case. Due to domestic politics, the United States was not involved in the League's work on double taxation until 1927, and thus was limited in its influence given the continuous nature of the League's work. In contrast, Britain exerted more influence, as it was involved in the League's work from the beginning and was considered 'a great economy' that needed to agree to the proposals. Many compromises were made for the British position.

Finally, Chapter 8 discusses the historical insights drawn from the detailed account of the drafting of the 1928 Models. There are many parallels between the discussions that took place almost a century ago and the discussions that have taken place in recent decades, and which continue today. As we contemplate further international tax reform, history provides important lessons on the conditions which bring about action, and on the principles that guided previous reformers.

2

Background

I Introduction

This chapter is in three parts. Section II provides an overview of international double taxation, which the League was tasked with alleviating. Also included in this overview is a summary of the theories of taxation that informed the League's work on double taxation, particularly in the early stages when they were developing the relevant principles. Section III provides an outline of the economic and political circumstances of the 1920s, so that the League's work can be understood in context. Finally, Section IV offers a précis of the League's formation, its structure, and how it came to be involved in international double taxation.

II International Double Taxation

Simply defined, double taxation is 'the taxation of the same person or the same thing twice over'.[1] The OECD states that international juridical double taxation arises where more than one country imposes comparable taxes on the same taxpayer, on the same subject matter, and for the same time period.[2] This contrasts with economic double taxation which arises where the same amount is taxed twice in the hands of two different taxpayers. For example, the profits of a company may be taxed in the company's hands through a corporate income tax, and then taxed again in the shareholder's hands when distributed as a dividend through a personal income tax. DTAs are generally concerned with international juridical double taxation and, to a lesser extent, with economic double taxation.

International juridical double taxation can arise in several ways.[3] The best-known example is source-residence conflict, whereby one country

1 Edwin Seligman, *Essays in Taxation* (Macmillan, 1895), p. 95.
2 OECD, *Model Tax Convention on Income and on Capital 2014: Full Version* (2015), p. I-1.
3 For a discussion of the different principles of taxation and examples of international double taxation in the 1920s, see Clyde Crobaugh, 'International Comity in Taxation'

taxes an amount on the basis that it is sourced in that country, while another country taxes the amount on the basis that it is the income of a resident of that country. For example, a resident of country A may own an investment property in country B and earn rental income in country B. Country A would tax the amount based on residence, while country B would tax the amount based on source, resulting in the same amount being taxed twice for the same taxpayer. Addressing source-residence conflicts is one of the primary aims of DTAs. Double taxation may also arise due to a conflict of residence, whereby a taxpayer is considered a resident of two countries under each country's domestic tax rules. For example, a company may be a resident of country A as it is incorporated in that country, but may also be a resident of country B where it has its management and control. Both countries would tax the company's income based on residence, resulting in double taxation. Residence-residence conflicts are addressed in DTAs through tiebreaker rules. Finally, double taxation can also arise due to a conflict of source. For example, country A may tax royalties for a patent on the basis that the patent was developed in that country, while country B may tax the royalty on the basis that it was paid in that country. Source-source conflicts may be addressed in DTAs by stipulating source rules for particular types of income which help determine the country of source.

A Theories of Taxation

Taxation based on source or residence stems from fiscal sovereignty or jurisdiction to tax, which is to be distinguished from the power to tax or sovereignty.[4] The power to tax stems from the citizen–state relationship, and, while theoretically expansive, it is generally limited to a country's jurisdiction to tax as a matter of customary international law.[5]

(1923) 31 *Journal of Political Economy* 262 at 262–3; F. Allemès, 'The Problem of Double Taxation' (1926) 17 *Economica* 148 at 148–56.

4 While there is some question as to whether fiscal sovereignty and jurisdiction are in fact synonymous, it is generally accepted in international tax literature that they are, with fiscal sovereignty being distinguished from sovereignty generally. See, for example, Rutsel Silvestre Martha, *The Jurisdiction to Tax in International Law: Theory and Practice of Legislative Fiscal Jurisdiction* (Kluwer Law and Taxation, 1989), p. 13.

5 As to whether or not there is such a thing as customary international tax law, see Arnold Knechtle, *Basic Problems in International Fiscal Law* (W. E. Weisflog trans., Kluwer, 1979), pp. 146–8; Asif Qureshi (ed.), *The Public International Law of Taxation: Text, Cases and Materials* (Graham & Trotman, 1994), pp. 11–16, 146–8; Reuven Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime*

Jurisdiction addresses when a state has the right to tax, while sovereignty gives rise to that right.

1 Power to Tax

Two theories which dominated early thinking regarding the power to tax are the protection theory of taxation and the control theory of taxation.[6] The protection theory is predicated on the notion that countries exist to protect their citizens from harm, and tax is imposed as payment for that protection.[7] It is suggested that protection given to a person within a country provides the government with the power to tax that person; that protection given to property creates the right to tax that property; and that protection given to the doing of an act creates the right to tax that act.[8]

The control theory of taxation, on the other hand, suggests that tax is imposed simply because it is within the right or power of the sovereign to do so, and does not depend on the provision of any services or protection by the government.[9] This theory corresponds to the sovereignty theory of taxation whereby the right to tax is justified in international law as an attribute of statehood or sovereignty, and exercised in varying manners according to national policy.[10] Both theories are not without their flaws,[11] but the control or sovereignty theory is generally accepted as authoritative, as it is more widely accepted by commentators and has gained acceptance in international case law.[12]

(Cambridge University Press, 2007), pp. 1–37. For a discussion of the application of general international law to fiscal jurisdiction in the absence of tax treaties and custom, see Martha, *The Jurisdiction to Tax in International Law*.

6 Arthur Harding, *Double Taxation of Property and Income* (Harvard University Press, 1933), pp. 22–7.

7 For further discussion of this theory, see Joseph Beale, 'Jurisdiction to Tax' (1919) 32 *Harvard Law Review* 587; Joseph Beale, 'The Progress of the Law, 1923–1924 Taxation' (1925) 38 *Harvard Law Review* 281. Protection theory is similar to what some authors identify as contractual theory, whereby taxation is the payment for goods and services received from the taxing state; and ethical theory, which states that taxation is a return for advantages received from the state. See A. R. Albrecht, 'The Taxation of Aliens under International Law' (1952) 29 *British Yearbook of International Law* 145 at 145–6; Martha, *The Jurisdiction to Tax in International Law*, pp. 19–21.

8 Harding, *Double Taxation*, p. 23.

9 For further discussion of this theory, see Charles Carpenter, 'Jurisdiction over Debts for the Purpose of Administration, Garnishment, and Taxation' (1918) 31 *Harvard Law Review* 905 at 905–8.

10 Albrecht, 'The Taxation of Aliens', 148.

11 Harding, *Double Taxation*, pp. 23–8.

12 Martha, *The Jurisdiction to Tax in International Law*, p. 23.

2 Jurisdiction to Tax

Jurisdiction to tax was historically founded upon political allegiance whereby countries taxed persons and corporations based on citizenship.[13] The doctrine of political allegiance has been strongly criticised as outdated due to the international migration of persons and corporations, which generally results in nominal ties to the mother country.[14] Only two countries still tax citizens who are non-residents on their worldwide income – Eritrea and the United States. The doctrine of political allegiance soon gave way to taxation based on the residence of the taxpayer or the source of the income.

The concepts of 'residence' and 'source' are ubiquitous in international taxation and have their foundations in the exchange and ability-to-pay theories of taxation. The exchange theory of taxation relates to philosophical social contract theory and suggests that taxpayers should pay tax in the country where there is an exchange of goods and services between the taxpayer and the government. This is based on cost theory, whereby taxes represent the cost of services performed by government, and benefit theory, whereby taxes are paid in return for the benefits provided by government. Exchange theory dates back to Hobbes, who said that 'every man payeth equally for what he useth'.[15] It is arguably 'just', as it distributes taxes in accordance with the distribution of governmental goods and services.[16] However, it is impractical (perhaps impossible) to determine each person's use of governmental goods and services, and exchange theory was generally relegated in favour of the faculty or ability-to-pay theory of taxation.[17]

The faculty or ability-to-pay theory dates back to Adam Smith and the first of his four maxims, which stated that '[t]he subjects of every state

[13] On citizenship as a basis for taxation, see Pamela Gann, 'The Concept of an Independent Treaty Foreign Tax Credit' (1983) 38 *Tax Law Review* 1.

[14] G. W. J. Bruins et al., *Report on Double Taxation: Submitted to the Financial Committee* (League of Nations, 1923), p. 19 ('the Economists' Report') (the first group of experts to examine the problem of international double taxation for the League).

[15] Thomas Hobbes, *Leviathan* (Richard Tuck ed., Cambridge University Press, 1991), p. 239.

[16] James Buchanan, *Fiscal Theory and Political Economy: Selected Essays* (University of North Carolina Press, 1960), pp. 19–23.

[17] Seligman, one of the authors of the Economists' Report, and a leading academic on the issue of double taxation, stated: '[N]othing is more firmly established than the substitution of the ability theory for the old benefit theory in taxation. To do as Professor Adams [the leading US representative on double taxation] now attempts, and to blur these sharp distinctions, is to reopen the Pandora's box of confusion': E. M. Patterson et al., 'Federal Taxes upon Income and Excess Profits: Discussion' (1918) 8(1)(Suppl.) *American Economic Review* 36 at 43. The League's Experts refer to both exchange theory and ability-to-pay during their discussions.