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WHO INVENTED THE SINGLE TAX PRINCIPLE?

I. INTRODUCTION

In 1997, I wrote an article on the international tax challenges posed by the then-nascent electronic commerce, in which I suggested that the international tax regime is based on two principles: the benefits principle and the single tax principle. The benefits principle states that active (business) income should be taxed primarily by the country of source, and passive (investment) income should be taxed primarily by the country of residence. This is the famous compromise reached by the four economists at the foundation of the regime in 1923 and is not particularly controversial. It is embodied in every one of the over 3,000 tax treaties that reduce taxation at the source of passive income while allowing source countries to tax active income if there is a permanent establishment.

The single tax principle states that cross-border income should be taxed once at the rate determined by the benefits principle. In other words, cross-border income should be taxed only once at the source-country rate for active income and at the residence-country rate for passive income. But if the preferred country (i.e., source for active, and residence for passive) does not tax, it is incumbent upon the other country to do so because otherwise, I argued in my article, double non-taxation would result, which is just as damaging as double taxation. This argument remains hugely controversial. While there are indications that the single tax principle was the idea underlying the adoption of the foreign tax credit by the United States in 1918, as far as tax treaties are concerned, the United States did not accept the single tax principle until more recent times.

The United States' first tax treaty with France in 1932 reduced withholding taxes on French investors in the United States at a time when France was purely territorial and did not tax its residents' foreign source income. And as recently as 1984, the

2. Id. at 520.
5. Id.
United States entered into a treaty with a tax haven, the Netherlands Antilles ("Antilles Treaty"), which U.S. multinationals used to borrow abroad with no withholding on the interest.8

However, in more recent times, U.S. treaty policy—and arguably domestic law as well—has changed to incorporate the single tax principle. After the United States terminated the Antilles Treaty, it not only refused to enter into additional treaties with tax havens like Singapore, but also insisted on introducing "limitation on benefits" (LOB) clauses into its existing treaties to prevent double non-taxation. Recently, the Organisation for Economic Cooperation and Development (OECD) endorsed the single tax principle as part of its Base Erosion and Profit Shifting (BEPS) project.9

In 1998, I engaged in a debate with Professor H. David Rosenbloom of New York University in which he denied both the existence of an international tax regime and the validity of the single tax principle, attacking, for example, the U.S. double-consolidated loss rule, which reflects that principle.10 Subsequently, other well-known tax professors like Michael Graetz, Julie Roin, and Dan Shaviro have taken Rosenbloom's position by denying the existence or utility of an international tax regime.11 Others, like Mitchell Kane and Adam Rosenzweig, have specifically critiqued the single tax principle.12 On the other hand, Yariv Brauner, Diane Ring,13 and others14 have supported my position on the single tax principle's existence in international tax law.


12. See, e.g., Kane, supra note 6, at 114–16; Adam H. Rosenzweig, Harnessing the Costs of International Tax Arbitrage, 26 VA. Tax Rev. 555, 588–89 (2007).


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This is not just a theoretical debate among tax academics. An entire industry of tax arbitrage has arisen, which seeks to exploit differences among various countries’ tax regimes in order to create double non-taxation. In 1997, the United States adopted the “check the box” rule, which vastly enhanced the capability of sophisticated tax lawyers to use hybrid entities as well as hybrid instruments (such as debt in one country and equity in another) to achieve double non-taxation. Other forms of double non-taxation result from shifting profits via transfer pricing or deductible interest, as well as royalty payments, to tax havens. All of these activities cost governments trillions of dollars in revenue and are condemned by the single tax principle.

It is therefore important to establish the historical origins of the single tax principle, which I attempt to do in the following pages. A review of the historical record shows that, in fact, it was Rosenbloom himself who gave life to what was previously a somewhat inchoate principle in the first U.S. model tax treaty, which was drafted under his own auspices as International Tax Counsel in 1981. The rest, as they say, is history.

The remainder of this article discusses the historical origins of the single tax principle. Section II explains the creation of the single tax principle in the context of U.S. taxation of U.S. residents from 1918 and its application to U.S. taxation of non-residents in the treaty context from 1981 onward. Section III concludes by explaining the implications of this historical analysis to the current discussion of the single tax principle in the OECD and in the United States.

15. This phenomenon has many names—the current popular one being “stateless income”—but I prefer the old-fashioned “double non-taxation” because it resonates with the history of the regime (see below); “stateless income” is a misnomer because the income is booked in states (tax havens are fully fledged sovereign states).

16. See generally Treas. Reg. § 301.7701-2 (Westlaw 2014). See also Treas. Reg. § 301.7701-3 (Westlaw 2006). The “check the box” rule allows U.S. taxpayers, in most cases, to elect whether a foreign entity will be treated as a corporation or as a non-taxable entity by checking a box on a form attached to their tax return (e.g., a partnership or branch) for U.S. tax purposes, while keeping its character as, for example, a corporation for foreign tax purposes. This rule led to the erosion of U.S. taxation of U.S.-based multinationals due to its implications for the anti-deferral and foreign tax credit rules. As a result, U.S.-based multinationals now have $2 trillion offshore that have been subject to almost no foreign or U.S. tax, in clear violation of the single tax principle that underlay both Subpart F (I.R.C. §§ 951-965 (Westlaw 2014)) and the foreign tax credit (I.R.C. §§ 901-905 (Westlaw 2012)). IRM 4.61.5.3 (May 1, 2006), available at http://www.irs.gov/irm/index.html.


II. THE HISTORICAL ORIGINS OF THE SINGLE TAX PRINCIPLE

The rejection of double non-taxation under tax treaties can be traced to the first U.S. model tax treaty from 1981 ("1981 U.S. Model Tax Treaty"). Before that model, while the United States took steps to restrict double non-taxation of its residents, it generally permitted double non-taxation of non-residents. After 1981, the United States increasingly limited double non-taxation of non-residents, leading to the adoption of the single tax principle by the OECD.

The single tax principle states that income should be subject to tax only once, and thus rejects both double taxation and double non-taxation. The rejection of double taxation was, of course, the inspiration for the entire international tax regime. But where does this rejection come from?

To some extent, the rejection of double non-taxation was already implicit when the United States adopted the foreign tax credit in 1918—a time when most of the other countries had exemption systems. The foreign tax credit ensures that income not subject to tax at source will be subject to tax by the United States as the residence jurisdiction. To justify the foreign tax credit, its architect, T.S. Adams, wrote, the "state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax." According to Adams, the exemption system should be rejected.
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because it means that the residence country does not impose a tax regardless of whether or not the income was taxed at source.\textsuperscript{27}

The first model treaty, drafted by the League of Nations Committee of Technical Experts in 1927,\textsuperscript{28} explicitly acknowledged this principle in its commentary. The commentary states:

From the very outset, [the drafters of the model convention] realised the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international co-operation, should prevent certain incomes from escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once, and once only.\textsuperscript{29}

However, this argument applied to the United States solely as a residence country, not as a source country.\textsuperscript{30} As a residence country, the United States adopted a foreign tax credit and not an exemption system in 1918, and also adopted the foreign personal holding company rules in 1937, to prevent double non-taxation of its residents.\textsuperscript{31} As a source country, however, our first income tax treaty concluded with France in 1932, and it reduced U.S. withholding taxes (e.g., on royalties to zero) at a time when France was purely territorial and did not tax foreign source income.\textsuperscript{32} Thus, at approximately the same time as the United States was enacting the foreign personal holding corporation provisions to ensure that its residents pay tax on income unlikely to be taxed at source, it was tolerating double non-taxation of U.S. source income earned by non-residents.\textsuperscript{33} The same tolerance applied to U.S. tax treaties, which were commonly extended to tax havens.\textsuperscript{34}

The first U.S. treaty indicating that double non-taxation of U.S. source income was inappropriate was the treaty with Luxembourg,\textsuperscript{35} which precluded the application

\begin{itemize}
\item \textsuperscript{27} See Graetz & O'Hear, supra note 7, at 1027-28.
\item \textsuperscript{28} T.S. Adams was one of the drafters of the first model treaty. Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, LEAGUE OF NATIONS Doc. G.216.M.85 II (Apr. 1927).
\item \textsuperscript{29} Id. (emphasis added).
\item \textsuperscript{30} See generally Graetz & O'Hear, supra note 7.
\item \textsuperscript{31} Id. at 1022; see also Eustice & Brantley, supra note 7.
\item \textsuperscript{32} See David R. Milton, Taxing Multinationals; The States Have Made It a Nightmare, N.Y. TIMES, Feb. 26, 1984, \S 3, at 32, available at 1984 WLNR 447203.
\item \textsuperscript{34} See Grady, supra note 17, at 626-31.
\end{itemize}
of reduced U.S. withholding rates to certain Luxembourgian holding corporations that were not subject to tax on a residence basis. Similar language appears in the 1963 protocol to the Antilles Treaty. Interestingly, these provisions were contemporaneous with the enactment of Subpart F of the Internal Revenue Code, which significantly limited double non-taxation for controlled foreign corporations (CFCs) by subjecting both passive and active income not taxed at source (base company income) to current U.S. tax at residence. However, the scope of the Antilles Treaty provision was limited by an agreement that an Antilles company could entitle itself to treaty benefits by either electing to be subject to a low 15% tax at residence, or owning 25% of the U.S. payor.

Similar limitations on particular types of holding companies appeared in the 1970 U.S. treaty with Finland and the 1975 U.S. treaty with Iceland. The 1975 U.K. treaty imposed an LOB on corporate residents if the tax imposed by the residence country was "substantially less" than the general corporate tax and 25% or more of the company was held by third-country residents. However, the limitation did not apply to U.K. close companies or to companies held by U.K. individuals, giving rise to Rosenbloom's comment that "it is difficult to discern a coherent U.K. treaty policy in the article." The 1978 protocol to the treaty with France likewise contained only narrow limitations.

In general, therefore, U.S. policy before 1979 did not significantly restrict double non-taxation in regard to U.S. source income, despite placing significant unilateral

36. See Rosenbloom, *Tax Treaty Abuse*, supra note 35, at 781. Stanley Surrey, who also was responsible for rejecting "tax sparing" by the Senate in the context of the Pakistan treaty hearings in 1957, oversaw the Luxembourg treaty. See Stanley S. Surrey, *The Pakistan Tax Treaty and "Tax Sparing"*, 11 *Nat'l Tax J.* 156 (1958). Tax sparing was rejected because it involved double non-taxation. I therefore suspect that if we investigated the unpublished Surrey papers at Harvard Law School, we would find considerable evidence that he further articulated the single tax principle, and I hope to undertake this search in the future.


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limits on double non-taxation when the United States was the country of residence.\textsuperscript{45} However, in 1979, following congressional hearings that revealed the extensive use of the Antilles Treaty by third-country residents, the U.S. Department of the Treasury announced its intention to reexamine the Antilles Treaty and a series of treaty extensions to current and former U.K. colonies.\textsuperscript{46} In 1981, the U.S. Treasury published the new 1981 U.S. Model Tax Treaty, which, for the first time, included a broad LOB provision applicable to both corporations and individuals.\textsuperscript{47} This provision provided that the benefits of reduced withholding under the treaty will not apply to non-publicly traded corporations residing in the treaty partner, unless over 75% of such corporations are owned by individual residents and their income is not paid out to residents of third countries.\textsuperscript{48} Additionally, the LOB provided that treaty benefits will not be available to corporations entitled to a significantly lower tax rate in their country of residence.\textsuperscript{49} Subsequent to the 1981 U.S. Model Tax Treaty, the LOB provision became a standard part of all U.S. treaties.\textsuperscript{50} Indeed, ever since the

\textsuperscript{45} See U.K. Treaty, \textit{supra} note 42, art. 16.


\textsuperscript{47} See 1981 U.S. Model Tax Treaty, \textit{supra} note 20, art. 16.

\textsuperscript{48} Id.

\textsuperscript{49} The provision states:

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless

   (a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and

   (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

   For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.

\textit{Id.}

\textsuperscript{50} The LOB provision was first included in the treaties with Jamaica (1980), New Zealand (1982), Australia (1982), Denmark (1983), France (1984), Cyprus (1984), and every subsequent U.S. treaty. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, U.S.-Jam., arts. 17, 24, May 21, 1980, 33 U.S.T. 2865 (1981); Convention for the
Senate in 1981 refused to ratify the treaty with Argentina unless it included an LOB, it has been clear that no U.S. treaty will be ratified without an LOB. And in 1986, Congress created a treaty override by adopting a "qualified resident" test (a simple LOB) in the context of the branch profits tax, which made it applicable to all U.S. treaties, including the majority that did not yet have an LOB provision.\footnote{See Richard Andersen, \textit{Analysis of United States Income Tax Treaties}, ¶ 1.03(a)(iii); I.R.C. § 884 (Westlaw 2007); Treas. Reg. § 1.884-0 (Westlaw 2008); see also I.R.C. § 7701(l) (Westlaw 2010) (overriding all U.S. treaties to impose a conduit financing test inspired by \textit{Aiken Indus., Inc. v. Comm'r}, 56 T.C. 925 (Westlaw 1971)).}

Some argue that the creation of the LOB provision had nothing to do with double taxation, but was meant to prevent the United States from having a "treaty with the world" (i.e., allowing any non-resident to achieve treaty benefits without residing in a treaty jurisdiction) by restricting treaty benefits to residents of that state and not allowing the extension of benefits to residents of other states, regardless of whether they were subject to tax at residence.\footnote{See McDaniel \textit{et al.}, supra note 21, at 183.} This, it can be argued, was also the purpose of terminating the treaties with the Antilles and other tax havens in 1987.\footnote{The United States terminated its income tax treaties with Aden and a group of other U.K. colonies: Aruba, Netherlands Antilles, Belgian Congo, Honduras, Malawi, and Nicaragua.}

But this view of the purpose of the LOB provision is inconsistent with the last paragraph of the 1981 model LOB, which explicitly makes the reduction of source-based taxation contingent on taxation at residence without regard to the ownership of the recipient of the income.\footnote{1981 U.S. Model Tax Treaty, supra note 20, art. 16, ¶ 3.} It is also inconsistent with the contemporary views held by Rosenbloom who, as International Tax Counsel from 1977 to 1981, was responsible for the inclusion of the LOB provision in the 1981 U.S. Model Tax Treaty and other treaties of that period.\footnote{See \textit{id}. art. 16; Rosenbloom CV, supra note 19.}

In an article published in 1983, Rosenbloom explained the policy behind the LOB provision:

Many commentators believe that existing international commerce is, to a considerable extent, structured on the assumption that liberal use of treaties will be tolerated . . . . The fundamental goal of tax treaties is removal of the negative effects of double taxation . . . . Since treaties are intended to eliminate double taxation, their benefits should flow to persons who, in the absence of the treaty, might be subject to double taxation. These are persons who, while potentially subject to tax in one country on either a source or a personal basis, are also subject to tax in the other country on a personal basis. A principal...
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task of treaty drafters, then, should be to identify those persons in each country who are subject to that country's personal taxing jurisdiction . . . . It may prove necessary in some cases to adopt special rules to ensure that taxation on a personal basis is not avoided altogether.56

While Rosenbloom later mentioned the "treaty with the world" problem and the revenue impact of allowing third-country investors to benefit from a treaty, the principal thrust of these observations is that the United States (as a source jurisdiction) should not reduce its withholding tax, unless it has some reasonable assurance that the income will be subject to tax on a residence basis.57

By 1981, the single tax principle had become a foundation block of U.S. international tax policy. This is evidenced by the combination of the foreign tax credit and Subpart F, which seeks to ensure that active income residence-based taxation will apply when there is no tax at the source, and the LOB provision, which seeks to ensure that passive income source-based taxation will apply when there is no tax at residence.58 As Rosenbloom stated, "One possible course would be for Country X not to enter into a treaty relationship unless it is satisfied that State Y will be likely to impose a full tax on all persons falling within the personal jurisdiction of State Y. In theory, then, at least a single, substantial tax will be collected."59

III. CONCLUSION

Although the single tax principle remains controversial, LOB provisions have proliferated, and starting in the early twenty-first century, the OECD adopted the single tax principle as part of its model treaty.60 The OECD model treaty's commentary on Article 1 contains both a full-fledged LOB provision and a discussion of partnerships and other entities not subject to tax, which are excluded from the scope of the substantive articles.61 According to the OECD view, these provisions apply to any tax treaty that contains the language of Article 1, which is every tax treaty (regardless of whether it was negotiated before or after the changes to the commentary were adopted).62

Thus, the key date for the creation of the single tax principle was 1981. Until 1979, the United States encouraged using the Antilles Treaty to enable U.S. corporations to borrow overseas without imposing withholding tax on the interest.63 This former practice is similar to the current policy of India, which seeks to avoid

57. Id. at 774–75.
61. OECD Commentary, supra note 21, ¶¶ 1–4 (2010).
62. Id. ¶ 21.5.
63. McDANIEL ET AL., supra note 21, at 183.
double taxation. Hong Kong may fulfill a similar role for China, Cyprus for Russia, and the Netherlands for Brazil.

The United States stopped implementing this policy in 1981, the cessation of this policy created a huge gap in the single tax principle. In 1984, the United States enacted the portfolio interest exemption, which resulted in adverse consequences for developing countries and the United States' own ability to tax its residents on worldwide income. The repercussions of this portfolio interest exemption are still present today. However, this gap in the single tax principle may be closed if the emerging network of intergovernmental agreements under the Foreign Account Tax Compliance Act leads to a genuine automatic exchange of information. There are also signs that even the BRICS countries are reconsidering, with Brazil for example, imposing a tax on payments to tax havens. The next step may be the introduction of an LOB provision into the OECD model itself, in addition to the commentary. Another step may be the incorporation of the single tax principle into the BEPS proposals to combat the abuse of both hybrid instruments and hybrid entities.


66. See Crandall, supra note 8, at 363-65 (discussing the United States’ efforts to eliminate treaty shopping).


70. Andrea Bazzo Lauletta et al., Brazil Publishes Its Black and Greylists, 21 INT’L TAX REV. 72, 72 (2010).

71. Hugh Ault, who is a major influence on the BEPS endeavor, cites the single tax principle in the beginning of his recent article on BEPS. See Hugh J. Ault, Some Reflections on the OECD and the Sources of International Tax Principles, 70 TAX NOTES INT’L 1195, 1195 (2013); see also Public Discussion Draft, supra note 9, at 2 (discussing steps to prevent the granting of treaty benefits in inappropriate circumstances).