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The Historical Origins of the Multilateral Tax Convention

Reuven Avi-Yonah[1]
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ABSTRACT

The current OECD/G20/IF effort to create a new international tax regime (ITR) for the 21st century is built primarily around multilateralism. Both pillars of BEPS 2.0, and especially Pillar 1, require a multilateral tax convention (MTC). This stands in sharp contrast to the development of the ITR between its origins a century ago and the beginning of the BEPS effort a decade ago. In the 1923-2013 period, the ITR was built on bilateral treaties and unilateral actions, not on multilateralism. Unilateralism and bilateralism in tax stands in sharp contrast to other areas of international tax law such as trade law (based on multilateral treaties since its origins in 1948) and investment law (based on bilateral treaties with MFN clauses that make it effectively multilateral).

This paper will survey the efforts to create a MTC from the beginnings of the ITR until BEPS 2.0. Part 1 will discuss the failed efforts of the League of Nations to create a MTC and the reasons for failure. Part 2 will summarize the development of the ITR from the first bilateral models to BEPS 1.0 and discuss to what extent it involves multilateralism because of the reliance on the OECD and UN models. Part 3 will explain why the multilateral instrument (MLI) that was included in BEPS 1.0 is not a true MTC. Part 4 will survey the BEPS 2.0 effort to develop a true MTC. Part 5 will conclude by discussing under what conditions can a true MTC emerge and what it might look like.

The current OECD/G20/IF effort to create a new international tax regime (ITR) for the 21st century is built primarily around multilateralism. Both pillars of BEPS 2.0, and especially Pillar 1, require a multilateral tax convention (MTC). This stands in sharp contrast to the development of the ITR between its origins a century ago and the beginning of the BEPS effort a decade ago. In the 1923-2013 period, the ITR was built on bilateral treaties and unilateral actions, not on multilateralism. Unilateralism and bilateralism in tax stands in sharp contrast to other areas of international tax law such as trade law (based on multilateral treaties since its origins in 1948) and investment law (based on bilateral treaties with MFN clauses that make it effectively multilateral).

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I. The League of Nations and the Failure of the MTC[3] 1. The Beginning: the Nineteenth Century – 1914

For very good reasons, it is not unusual for any research that reviews the historical development of the current international tax regime to start with the post- World War I era[45] (and more specifically with the publication of the Economists' Report by the League of Nations in 1923).[6] Indeed, it makes perfect sense to start with the Economists' Report as that report represented the first international effort by tax experts from different countries to explore solutions to the emerging problem of taxation of cross-border transactions. The Economists' Report laid out four general approaches to avoiding cross-border double taxation,[7] and became the starting point for all later studies and reports on the subject.[8] This eventually led to the formation of the first OECD model tax treaty in 1963.[9] However, although the Economists' Report was the first international report on the subject, it was developed and written in a certain context. Even before World War I countries took actions to prevent (or at least alleviate) international double taxation through unilateral and bilateral measures.[10] These efforts to avoid double taxation constituted the background against which post- World War I efforts to deal with double taxation took place. By examining the pre- World War I period, I hope to provide a better understanding of the development of the initial features of the international tax regime in the post-World War I era. The first significant developments in the pre-World War I period in the field of international taxation occurred during the last quarter of the nineteenth century.

However, to enable a comprehensive understanding of those developments, I will start with a general description of the background to developments in international taxation in this period.

1.1 General Background

Prior to the nineteenth century, international double taxation was not an issue largely because of the relatively limited volume of international trade and the predominance of nonincome taxes (mainly property taxes).[11] This, of course, changed during the course of the

[3] This part is based on the second author's unpublished JSD dissertation, Crossing the Barrier: Towards a Multilateral Tax Treaty (NYU, 2005).

[4] See Reuven S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301; H. David Rosenbloom & Stanley I. Langbein, United States Tax Treaty Policy: An Overview, 19 Colum. J. Transnat'l L.

[5] (1981) (hereinafter, Rosenbloom & Langbein); Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021 (1997) (hereinafter, Graetz & O'Hear); Hugh J. Ault, Colloquium on Corporate Integration: Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 47 Tax L. Rev. 565; see also Mitchell B. Carroll, The Historical Development of Income Tax Treaties, INCOME TAX TREATIES, Jon Bischel (ed.), (New York: Practicing Law Institute, 1978). Carroll notes that in fact the first bilateral tax treaty was concluded in 1899, but he does not add much more than that.

[6] Report on Double Taxation Submitted to the Financial Committee, League of Nations Doc. E.F.S.73. F.19 (1923) (hereinafter, the Economists' Report).

[7] See the Economists' Report, *supra* note 3, in Part II Section B, discussed below in Section 2.1.

[8] See below in Section 2.1.

[9] OECD Committee on Fiscal Affairs, Model Tax Convention on Income and Capital, 1963 and 1977. OECD MODEL INCOME TAX TREATIES AND COMMENTARIES (London: Kluwer, 1987).

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nineteenth century, and this change was driven by political, economic, and fiscal reasons, all of which can be linked to the growth of capitalism and the important role of capital in the world economy.[12] Following the discovery of the New World, a huge stream of wealth found its way from the new territories into the local and relatively small economies of Europe, and this tremendously impacted the political structure of Europe.[13] Among the changes that this flow of capital brought were the need for national armies to preserve national capital, the establishment of industries on a much larger scale, and the emergence of the concept of national wealth.[14] Nations started to focus on protecting their national wealth and consequently economies started to become more regulated by governments, a phenomenon referred to as mercantilism.[15] Under the mercantile system, as a way to preserve national wealth, governments discouraged imports and thus international trade was limited. Consequently, there was no real reason for the issue of international double taxation to arise. On the political level, the growth of nationalism and the creation of nations emphasized the rival interests of nations in taxing individuals (and later entities). Toward the end of the eighteenth century, with the emergence of the liberal theory of economics, the mercantile system started to come to an end and economies started to go through a process of liberalization.[16] Gradually, international trade became more significant, wholesale trade grew significantly, and with these developments the fiscal importance of capital

[10] See below in Section 1.2.3.

[11] The main types of levies then used to finance governments were property taxes, customs, and many other types of duties and charges. For a short survey of taxation in the Middle Ages see Edwin R. A. Seligman, THE INCOME TAX, A STUDY OF THE HISTORY, THEORY AND PRACTICE OF
INCOME TAXATION AT HOME AND ABROAD, second edition (Clark, NJ: The Lawbook Exchange, 2004), 41-57. For the history of the property tax see Edwin R. A. Seligman, Essays in Taxation (The Macmillan Company, 10th ed, 1925) Chapter II; for a general overview of economic developments at this time see David S. Landes, The Unbound Prometheus: : Technological Change and Industrial Development in Western Europe from 1750 to the Present; C. Cipolla, The Economic History of World Population (New York, Harvester Press, 1978).

[12] For a general review of the history of capitalism and related phenomena see D. S. Landes supra note 8; R. S. Duplessis & W. Beik, Transitions to Capitalism in Early Modern Europe, (Cambridge University Press ,1997); Eric Hobsbawn, The Age of Capital (Vintage, 1996).

[13] See, generally, Landes and Cipolla supra note 8 and R. S. Duplessis & W. Beik supra note 9.

[14] See, generally, Landes *supra* note 8.

[15]Mercantilism is usually placed in the period 1600-1800. For mercantilism in general see Laurence Bradford Packard, The Commercial Revolution, 1400-1776: Mercantilism-Colbert-Adam Smith; Immanuel Wallerstein, The Modern World-System II: Mercantilism and the Consolidation of the European World-Economy, 1600-1750 (Academic Press, 1980).

[16] See generally Hobsbawn supra note 9.

grew enormously.[10] Once economies became relatively liberalized, fiscal considerations became of national importance. Along with the introduction of income taxes during the nineteenth century, the contemporary issue of international double taxation emerged.[11]

[10] See Hobsbawn *supra* note 9 at 304-308.

[11] Before the nineteenth century there were already issues of double taxation, but more with respect to general property tax and "death" taxes. See Edwin R. A. Seligman, DOUBLE TAXATION and INTERNATIONAL FISCAL COOPERATION (New York: Macmillan, 1928), pp. 32-37. However, the importance of these two taxes had gradually declined and the modern problem of double income taxation emerged mainly because of the events described below in this chapter.

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1.2 The Development of Trade and the Problem of Double Taxation

A major development during the nineteenth century regarding international trade was the process of standardization of customs and tariffs during the first half of the century. It seems that the first move in this direction was the law enacted in May 1818 in Prussia[12] that removed barriers to trade by standardizing more than 60 different tariffs on more than 3,500 types of goods. Between 1819 and 1823, Prussia concluded several tariff treaties with the northern states of Germany.[13] The southern states of Germany reached a customs union of their own in 1828.[14] In 1833 the respective customs unions of the southern and northern states concluded a comprehensive customs union, the Zollverein, which covered 26 million people and facilitated trade among the various German states.[22] Foreign countries negotiated with the Zollverein and barriers to trade gradually started to be eliminated. This trend of reducing "border taxes," together with the industrial revolution, which led to the development of mass production methods, paved the way for the tremendous growth in international trade and later in crossborder investment. However, due to the slower expansion of income taxes throughout Europe;[15] and maybe also because income taxes were not perceived at that time as imposing barriers to trade, it was not before the last third of the nineteenth century that countries started to take actions to relieve double taxation.

Outside the shipping industry, measures to eliminate double taxation evolved in three somewhat different contexts. First, within a federation: members of the same federation were concerned about intra-federation double taxation. Second, within an empire, these attempts were usually focused on the elimination of double taxation between a colony and the mother state and not among the colonies.[16] Third, in the international context, sovereign states totally independent of each other took measures to eliminate double taxation. While our concern here is to lay out the background against which the contemporary bilateral tax treaty network evolved, it might be useful to also briefly outline the early attempts to prevent double taxation in the two first-mentioned frameworks (federations and empires) as these were actually the first attempts to alleviate double income taxation. It was thereafter and based on that experience that sovereign countries started to deal with double international taxation.

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[12] For a detailed analysis of this law and its impact see Marriot & Robertson, The Evolution of Prussia: The Making of an Empire (Oxford University Press, 1937), 290.

[13] See Marriot & Robertson *ibid* at 291.

[14] See Marriot & Robertson *ibid* at 292.

[22] See Marriot & Robertson *ibid* at 293.

[15] The United Kingdom is considered to have been the first nation to introduce an income tax (for some other countries that tried to introduce progressive taxes but not a genuine income tax, see Edwin R. A. Seligman PROGRESSIVE TAXATION in THEORY and PRACTICE (American Economic Association, 1909) e.g., Germany at 46 and Switzerland at 62-62). The general income tax was introduced in Britain in 1799 in order to meet the increasing cost of war with the French during the 1790s. However, the tax was repealed later and then re-introduced in 1842 as a flat rate tax. In Germany, Baden had a class tax, which was in fact a type of income tax, in place since 1820; Prussia, Austria, and Bavaria introduced an income tax in 1847, 1848, and 1850, respectively; and France introduced a general income tax only in 1909; see Seligman THE INCOME TAX, A STUDY OF THE HISTORY *supra* note 8 pp. 60-72, 78-82, 111-114, 128-133, 223-227, 329-331.

[16] This is understandable taking into account that most of the international activity involving colonies was carried out by nationals of the mother state; the British Empire is the best example, discussed below.

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1.2.1 Within a Federal Union

Within a federal union (or a federation) the issue of double income taxation arose among the members of the federation. Following is a description of the attempts to alleviate double income taxation in Germany, Switzerland, and the United States, three major federations that tried to tackle this issue during the nineteenth century.

<u>*Germany*</u>. The first significant attempts to handle double taxation within a federal union were in Germany,[17] where a federal law was enacted in 1870.[26] According to this law (which was supplemented by further legislation in 1909),[27] a German citizen was subject to direct state taxes only in the state of his domicile or residence. Real property and so-called "fixed industry"[18] assets were subject to tax in the state of location of the business or the real property. In fact, Germany conferred exclusive taxing rights on its member states based on the type of income involved: income generated by businesses and real property was taxed only by the source state, and other types of income were taxed only by the residence state. After World War I, taxes were assessed and collected by the federal government, and then apportioned among the different states pursuant to a formula; this of course eliminated almost entirely most of the issues of inter-state double income taxation.

<u>*Switzerland.*</u> Switzerland adopted a federal constitution in 1848 which was amended significantly in 1874. The Swiss Constitution of 1874 ordered the federal government to enact laws preventing inter-cantonal double taxation. However, the federal government, instead of dealing directly with this sensitive issue, transferred, by way of legislation, the responsibility for preventing inter-cantonal double taxation to the federal courts.[19] At the beginning, the Swiss courts primarily followed principles similar to the German ones, described above, with an exception being that only the residence canton was allowed to impose income taxes on real property. This method eliminated most of the inter-cantonal double taxation issues because the local governments financed their needs by imposing property taxes and income tax on labor. Thus, personal property and labor were taxed only in the canton of residence while real property was subject to property tax in the canton of its location. The same principles were also applied to inheritance taxes.

<u>*USA.*</u> In the United States the role of eliminating double income taxation was, at the beginning, vested in the judiciary. However, the federal courts intervened only in extreme cases which might have been seen as involving an infringement of justice.[30] The role of the courts was negative, mainly to prevent injustice, rather than the positive one of eliminating double taxation. Inter-state double taxation was not considered unconstitutional. Thus the Supreme Court stated:

> *No doubt it would be a great advantage to the country and to the individual States if principles of taxation could be agreed upon which did not conflict with each other, and a common scheme could be adopted by which taxation of substantially the same property in two jurisdictions could be avoided. But the Constitution of the United States does not go so far.*[20]

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[17] It is interesting to note that at the beginning of the nineteenth century the German states were also pioneers in unifying customs and tariffs among themselves, in the accord known as the Zollverein. [26] See Seligman, Essays in Taxation, *Supra* note 8, at 116 [27] See Seligman, Essays in Taxation, *Supra* note 8, at 116-117.

[18] The previous term for "permanent establishment".

[19] See Seligman, International Fiscal Cooperation, *supra* note 15, at 39.

[30] See the cases described below.

[20] Kidd v. Alabama, 188 U.S. 730, 732.

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In another case the Supreme Court held that inter-state double taxation was not prohibited double taxation under the Constitution of Georgia because a tax levied by another state was not considered a tax under the Constitution of Georgia.[21] Unsurprisingly, the achievements of the federal courts in eliminating double taxation were very modest. With respect to real estate court decisions provided that it would be subject to tax only in the state of location. However, regarding other types of properties and inter-state business income the rules were more complicated. In addition, states discriminated against non-residents by not granting them the same exemptions as residents,[22] or limiting them in their ability to use deductions against income derived within the state.[23] The federal courts did not always treat these cases consistently. The more significant achievements in eliminating inter-state double taxation in the United Sates were due to the growth of the economy, which resulted in increased cross-state trade, which in turn led to enormous pressure by the business community to eliminate inter-state double taxation.[24] The pressure to deal with inter- state double taxation arose mainly in the business of transportation and in 1922 a special committee was established in order to propose methods to apportion state taxes.

The main principles that were followed at the federal level in attempting to exclude double taxation were that individuals should be subject to income tax according to the place of their domicile, while real property and businesses should be subject to tax according to their location. The different ways in which these principles were implemented seem to have been the result, among other things, of the political interrelationships between the federal government and the states. While in Germany the federal government had enough political power to enact laws assigning taxing rights among the states, this was not the case in Switzerland and the United States. As described above, the Swiss federal government preferred (despite an explicit provision in the federal constitution) to forward this delicate issue to the federal courts. In the United States, the power of the federal legislature and the federal Supreme Court were perhaps too limited at that time to enable either of them to step into this very sensitive issue of states' revenues; this would explain why the Supreme Court intervened only in cases of severe injustice.

1.2.2 Within an Empire

Another setting in which attempts to eliminate double taxation were made is the colonymother state setting. Beginning in the sixteenth century, it was considered that the only way for a nation to become wealthier was by acquiring colonies around the world.[25] Thus, countries like England, France, Holland, Spain, and Portugal began to build empires, a tendency that started to weaken only with the industrial revolution.[26] The main example in this case is the British Empire. The problem of double income taxation within the British Empire began when the British
Governor General of India adopted the Income Tax Act of 1860.[38] Shortly afterwards, the issue of the simultaneous taxation of citizens by both the Indian and British governments arose. At the

[21] Wright v. Louisville and N.R.R. Co. 195 U.S. 219.
[22] Travis v. Yale and Towne Co., 252 U.S. 60.

[23] Shaffer v. Carter, 252 U.S. 37.
[24] See Seligman, International Fiscal Cooperation, *supra* note 15, at 44 and 159.
[25] Taggart & McDermott, The Essence of International Business (London: Prentice-Hall, 1993), 2.
[26] See Taggart & McDermott, *ibid*. For a general description of this trend see Hobsbawn *supra* note 9 at 135-145.
[38] The Income Tax Act of 1860 (February, 1860).

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beginning concern with the issue was limited to government officials; however, during the 1890s as the trade between England and India grew, pressure from the business community to eliminate double taxation started to build.[27] Beginning in 1905 the British Parliament addressed the issue annually; nevertheless, no measures were taken before 1916, when a British law provided some relief at the expense of the crown.[28] England adhered to taxation based on domicile and thus was reluctant to provide any relief for taxes paid to the Indian government.[29] The double taxation issues in the intra-federation and intra-empire contexts gradually, beginning in 1860, led to concerns regarding double taxation surfacing (naturally, due to the pressures from the business community) and being brought to the attention of the governments also in the international setting.

1.2.3 The International Setting

The third context to be considered, which is the main focus of this work, is double taxation among sovereign countries. In the international context, countries took measures to eliminate double taxation in two forms: unilateral measures, usually introduced through domestic legislation; and bilateral measures introduced through a tax treaty with another country. Although analytically it makes sense to examine the international background according to the type of measures taken (i.e., unilateral measures or bilateral ones); in order to follow the historical development of the current international tax regime, the approach taken here is chronological rather than analytical.

At the beginning of the nineteenth century, the Netherlands tried to handle double taxation in the shipping industry by one of the first reciprocal provisions in the context of international tax.[30] The Netherlands offered through its domestic law to exempt from the business tax (*droit de patente*) foreign ships of countries which were willing to give reciprocal treatment to Dutch ships.[31] However, this provision, which should have encouraged countries to use such reciprocal exemptions, did not lead many other countries to exempt Dutch ships from similar taxes. In 1843, with the growth of cross-border economic activity, Belgium entered into a treaty with France,[32] and in 1845 with the Netherlands,[33] regarding many aspect of mutual assistance.[34] Although these agreements are mentioned occasionally as tax agreements,[47] they

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[27] See Seligman, International Fiscal Cooperation, *supra* note 15 at 45-46 referring to the memorandums sent by the Royal Colonial Institute to Parliament in 1893 and again in 1896.

[28] See Seligman, International Fiscal Cooperation, *supra* note 15, at 46.

[29] In the "real" international context, the United Kingdom insisted (until after the Second World War) on taxation based on residence and thus was reluctant to give any relief for taxes paid to foreign governments.

[30] This was before the American Revenue Act of 1918, which provided that an alien resident in the U.S. might get relief from tax paid to a foreign government if this government granted similar concessions to Americans; and before the American Revenue Act of 1921, which provided a reciprocal exemption from tax of maritime profits.

[31] See John G. Herndon, Relief From International Income Taxation: The Development of International Reciprocity for the Prevention of Double Income Taxation (Chicago Callaghan and Co., 1932), p. 11 citing the Act of May 21, 1819, Official Journal of Laws No. 34, table XVI, subdivision E; See also Mitchell B. Carroll, Double Taxation Relief, Discussion of Conventions Drafted at International Conference of Experts, 1927, and Other Measures, Trade Information Bulletin No. 523, 1 (1927).

[32] League of Nations Doc. E.F.S. 26, F 7/10; See also Seligman, International Fiscal Cooperation, *supra* note 15, at 52.

[33] League of Nations Doc. E.F.S. 26, F 7/2.

[34] These were the first agreements entered into by countries regarding mutual assistance. These agreements were followed by those of other countries. In 1851, the Netherlands entered into a similar treaty with the Zollverein (the

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related to taxes only incidentally. These agreements were not aimed at eliminating double taxation, but only provided for some exchange of information in order to assist in tax collection. Treaties between countries designed to alleviate international double taxation were not concluded before the last quarter of the nineteenth century. During the second half of the nineteenth century, Switzerland introduced some unilateral measures to relieve double taxation. Interestingly, while the Swiss federal constitution did not allow double inter-cantonal taxation, and the federal government was responsible for eliminating such double taxation,[35] the responsibility for eliminating double international taxation remained in the hands of the cantons.[36] Most of the cantonal laws dealing with elimination of double international taxation applied to property taxes (which were, as described above, the main taxes in the various cantons at that time), and provided an exemption from domestic tax for property situated abroad and owned by canton residents.[37] These domestic provisions did not ask for reciprocal treatment as a prerequisite for granting the exemption. However, it was necessary to prove that the property was in fact subject to tax in the foreign jurisdiction (which was the justification for the exemption). One case where cantonal domestic law provided for relief from income tax (as opposed to property tax) was in the Canton of Thurgau. The Taxation Law of the Canton of Thurgau exempted from tax income derived by residents of the canton from businesses established abroad, provided that such income was subject to tax in the place where the business was carried on.[38]

On the other side of the Atlantic, the United States entered into many commercial treaties with other countries.[39] Some of these treaties contained specific provisions of equality in taxation. However, these provisions were mainly concerned with preventing discrimination against foreign nationals and were not about reliving double taxation. Most of these commercial treaties were signed at a time when there was no federal income tax in the United States; and thus, it seems inappropriate to regard them as tax agreements aiming to relieve international double taxation.[40]

Only in the last decade of the nineteenth century did bilateral agreements among sovereign states start to become a common tool for the elimination of double income taxation. In 1899, Germany entered into a special agreement with the Netherlands regarding income tax to be collected from a railway company that was constructing a railroad located in these two countries.[41] Germany and the Netherlands agreed to assess taxes on the railroad company in proportion to the length of the railroad located in their respective territories.[42] A more general bilateral double tax treaty, which is also considered to be the first tax treaty signed, is the one

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customs union of the German states). In 1872, the United Kingdom entered into such an agreement with the Canton of Vaud, and in 1873 Germany entered into a similar arrangement with the Netherlands. [47] See, for example, Seligman, International Fiscal Cooperation, *supra* note 15, at 52-53.

[35] See above in Section 1.2.1.

[36] This is mainly because the cantons were not willing to give away their treaty-making power. The first measures to relieve double taxation were unilateral measures introduced in the domestic laws of the cantons.

[37] Herndon *supra* note 40 at 13; the Taxation Law of the Canton of Schwyz (September 10, 1854); the Taxation Law of the Canton of Appenzell (April 25 1897) and the Taxation Law of the Canton of Thurgau (February 15 1898).

[38] Herndon *ibid* the Taxation Law of the Canton of Thurgau, Section 10(c) (Feb. 15 1898).

[39] Among others, Argentina, Belgium, France, Italy, and Japan. See Handbook of Commercial Treaties, U.S. Tariff Commission, 1923.

[40] See also Herndon *supra* note 40 at 17-18.

[41] League of Nations Doc. C. 345.

[42] See Herndon *supra* note 40 at 15.

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concluded between Prussia and the Austro-Hungarian Empire on June 21, 1899.[56] The general principle of this treaty was that nationals of the states would be subject to direct taxation (income tax) only in their state of domicile or residence. Nevertheless, real properties and business enterprises would be taxed according to their location or the location where the business was conducted. In the case of cross-border business, each country would be allowed to tax only the business income that was generated within its jurisdiction. Mortgages and interest therefrom would be taxed according to the place of the mortgaged property. It is interesting to note that the treaty included a provision according to which the signatory countries committed themselves to not changing their internal laws regarding the taxation of interest on bonds, annuities, or pensions.[43] This treaty was the kick-off for a series of double tax treaties concluded before World War I. Similar treaties were signed in the following decade between the Austro-Hungarian Empire and Lichtenstein (1901),[44] Saxony (1903),[45] Bavaria (1903),[46] Württemberg (1905),[47] Baden (1908),[48] and Hesse (1912).[49] Prussia also signed similar agreements with Luxemburg in 1909,[50] and with the Canton of Basle- Town in 1910.[51] The Canton of Basle-Town signed a similar agreement with Baden in 1913,[52] as did Luxemburg with Hesse.[53] These tax treaties were very simple, and basically divided the taxing rights along the lines that were drawn by the treaty entered into between Prussia and the Austro-Hungarian Empire in 1899, described above. It is interesting to note that even though double taxation could have been eliminated unilaterally (and this had been done),[54] countries chose to enter into bilateral agreements. There are several possible explanations for this. First, looking at the Dutch experience with a unilateral exemption for foreign ships conditioned on reciprocal exemption,[55] it can be seen that when a unilateral measure was conditioned on receiving reciprocal treatment, it was not followed by other

[56] Treaty of June 21, 1899 Between Austria-Hungary and Prussia for the Avoidance of Double Taxation which Can Result From the Application of the Tax Laws in Force in the Kingdoms and Lands Represented in the Imperial Council and in the Kingdom of Prussia, League of Nations Doc. E.F.S.40, F. 15. RGB1 158/1900. Although Prussia and Saxony entered into an agreement regarding direct taxes on April 16, 1869, and an agreement regarding the taxation of business enterprises entered into force between Austria and Hungary on December 18, 1869 (it was ratified in Hungary only on January 7, 1870), the treaty between Prussia and the Austro-Hungarian Empire is still considered by many as the first international tax treaty; see Graetz & O'Hear *supra* note 1; Carroll *supra* note 1; and Seligman, International Fiscal Cooperation, *supra* note 15; however, see Klaus Vogel, Double Taxation Conventions (Kluwer, 1997), p.17, stating that the first tax treaties were those concluded between Saxony and Prussia and between Austria

[43] Nowadays, countries that are signatories to a double tax treaty are free to change their internal law. However, with the exception of the United States in most cases the treaty law overrides domestic legislation.

[44] See Herndon *supra* note 40 at 16-17, the treaty between the Austro-Hungarian Empire and Lichtenstein, 1901.

[45] See Herndon *ibid;* the treaty between the Austro-Hungarian Empire and Saxony, 1903.

[46] See Herndon *ibid;* the treaty between the Austro-Hungarian Empire and Bavaria, 1903. Later a new treaty was signed on July 3, 1913.

[47] See Herndon *ibid;* the treaty between the Austro-Hungarian Empire and Württemberg, 1905.

[48] See Herndon *ibid;* the treaty between the Austro-Hungarian Empire and Baden, 1908.

[49] See Herndon *ibid;* the treaty between the Austro-Hungarian Empire and Hesse, 1912.

[50] See Herndon *ibid;* the treaty between Prussia and Luxemburg, 1909.

[51] See Herndon *ibid;* the treaty between Prussia and the Canton of Basle-Town, 1910.

[52] See Herndon *ibid;* the treaty between the Canton of Basle-Town and Baden, 1913.

[53] Other tax agreements were signed involving Italy, Greece, and Romania.

[54] See, e.g., the Swiss case above p. 20.

[55] Described above in section 1.2.3.

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and Hungary. It might be that the early treaties were seen as federal arrangements rather than agreements between independent countries: Austria and Hungary were parts of the Austro- Hungarian Empire and Saxony and Prussia were both parts of the German Republic that was declared in January 1871, two years after the conclusion of the treaty. Another explanation might be that in the League of Nations' collection of international agreements (League of Nations Doc. C.345.M.102.1928II.45) the first two treaties were not listed.

countries. On the other hand, granting such a relief without receiving reciprocal treatment may have been considered too costly. Second, the tendency was to tax individuals according to their domicile[56] and this could not be achieved by providing unilateral relief.[57] Therefore, it may have been thought that the appropriate solution for the double tax problem was to enter into a treaty. The pre-World War I treaties were pretty simple: they did not contain elaborate definitions or mechanisms to apportion cross-border tax revenues;[58] rather, they assigned the rights to tax certain taxpayers and types of income; and thus, these treaties, which heavily relied on the domestic tax systems, were made between countries with similar tax systems and policies.[59] Tax treaties today also rely on domestic law but there are at least two very crucial distinctions. First, the modern tax treaty is a closed scheme (though based on domestic laws): it contains definitions,[60] including what constitutes a taxable business activity,[61] how to source certain types of income,[62] and who is entitled to benefit from the treaty provisions.[63] Secondly, and related to this, today there are internationally accepted standards and as a result it is easier for two countries even with distinct tax systems (and policies) to negotiate a tax treaty because the starting point is usually these international standards which are embodied in (and reinforced by) the OECD work.[64] The facts that before World War I there were no such accepted standards regarding the coordination of national tax systems and that treaties did not provide for elaborate schemes may have led to the situation where only countries with similar income tax systems and policies were able to negotiate tax treaties, which would explain why the parties to such tax treaties were only continental European countries. An interesting question to pose here is why no multilateral treaty emerged during that period. Taking into account that only a few tax treaties were concluded during the pre-World War I period, and that the treaties were concluded among countries with similar tax systems, one could expect to see a multilateral treaty emerging in the area of international taxation, particularly after taking into account the fact that such treaty regarding customs and tariffs was concluded.[65] Nonetheless, there are no records indicating any efforts to reach such a multilateral accord. We can only hypothesize as to why such multilateral

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[56] See the German, Swiss, and British examples described above.

[57] Even though in theory the source jurisdiction could have provided an exemption to foreigners so that individuals would be taxed only in their residence jurisdiction, this was never the case. Naturally, this is understandable due to the fiscal interests of the source country.

[58] See, e.g., the treaty between the Austro-Hungarian Empire and Prussia, described above.

[59] For example, the United Kingdom and the United States did not enter into such a tax agreement; and France did not have an income tax before 1909 and thus, did not enter into any income tax treaty. The United Kingdom adhered to pure residence taxation and thus refused to recognize the source country's right to tax income derived from real property or business located outside the United Kingdom and owned by a UK resident.

[60] Articles 3 and 4 of the OECD Model Tax Convention on Income and on Capital 2005.

[61] See the definition of "permanent establishment."

[62] For example, Article 11 of the OECD Model Tax Convention on Income and on Capital 2005 sourcing interest payments.

[63] Limitation on Benefits and Non-discrimination provisions.

[64] The OECD Model Tax Convention will be discussed in Chapter 7 below.

[65] The Zollverein was signed in 1833 by all of the German states; see above Section 1.2.

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agreement did not emerge. One explanation might be that it was easier to conclude agreements where only two parties were involved. Another explanation might be that at that time, when capital did not flow so freely and easily, there was no need for a multilateral approach. Most cross-border activities involved two countries (there were no tax havens),[66] and thus it might be that double taxation was perceived as a two-country problem that required a two-country solution (i.e., a bilateral agreement). In the trade field the drive to conclude a multilateral agreement was the desire to eliminate the opportunity of a country to discriminate against another country's products and commodities, and it seems that these worries did not occur regarding income tax.[67]

1.3 Summary

The move from mercantilism to liberalized economies during the late eighteenth century, the gradual elimination of barriers to trade during the nineteenth century, and the shift to mass production techniques following the Industrial Revolution, set up the stage for the dramatic growth of capitalism and international trade. The growing cross-border activity and the shift of governments from property taxes to income taxes as a significant revenue raiser[68] were the triggers causing the issue of double income taxation to come to light (whether in a federal, imperial, or international context). Consequently, in the last quarter of the nineteenth century bilateral tax treaties started to emerge as a tool to eliminate international double taxation, and it was at these moments that the modern international taxation regime first started to crystallize. By 1914 there were about twenty tax treaties in force among several Continental European countries.[69] In the pre-World War I era the two main principles behind efforts to abolish double taxation were that individuals (and entities) should be subject to income tax in their state of domicile, and that business income and real properties should be taxed in the place of their location.[70] In 1914 World War I broke out and new developments in the area of international taxation occurred only after the war.

2. The Foundation of the Tax Treaty System: 1919 – 1946

2.1 The First International Contacts

2.1.1 The International Organization

The Paris Peace Conference of 1919 resulted in the peace treaty which officially brought World War I to its end, known as the Treaty of Versailles. Part I of the treaty established the

[66] For a general survey of the creation and spread of tax heavens in the twentieth century see Sol Picciotto, INTERNATIONAL BUSINESS TAXATION: A STUDY IN THE INTERNATIONALIZATION OF BUSINESS REGULATION (New York, 1992) 117-135.

[67] It is only in the last few decades that governments have started to use direct taxes to protect domestic industries from foreign competition. See generally Joel Slemrod and Reuven S. Avi- Yonah, (How) Should Trade Agreements Deal With Income Tax Issues?, 55 Tax L. Rev. 533; Mihir A. Desai and James R. Hines, The Uneasy Marriage of Export Incentives and the Income Tax (November 2000) NBER Working Paper No. W8009; available also at: http://ssrn.com/abstract=250364.

[68] For the dates of income tax implementation see *supra* note 20.

[69] See discussion above of the survey of tax treaties concluded before World War I, pp. 22-23.

[70] See discussions above of the German and Swiss cases, the unilateral provision of the Canton of Thurgau, the special agreement between Germany and the Netherlands, and the treaty between the Austro-Hungarian Empire and Prussia of 1899, which was followed by the other tax treaties.

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League of Nations,[71] which would play a major role in the international tax field during the next two decades. The same year, following the same principle that the world needed to have more international cooperation, the International Chamber of Commerce (ICC), a non-governmental organization, was established.[72]

Following World War I, governments needed to raise revenues to fund the war costs and this encouraged the shift toward using direct taxation (income tax) instead of relying on certain levies, duties, and customs. Moreover, income tax rates were substantially increased compared to the modest income tax rates before the war.[73] This trend, together with the growing volume of international trade and investment, increased the income tax burden on businesses. The business community in turn reacted by increasing lobbying efforts (basically through the ICC) to solve the international double taxation problem. Thus, not surprisingly, the ICC was the first organization to put the issue of international double taxation on the international agenda,[74] and called the League of Nations to start dealing with the issue of double taxation. Thereafter, the ICC appointed a committee on taxation (the ICC Committee) with representatives from six nations: Belgium, France, the United Kingdom, Italy, the Netherlands, and the United States.[75] The ICC Committee held meetings during 1921 and presented its conclusions to the ICC Congress held in London later that year.[76] Contrary to the opinion of the American representative,[77] the resolutions of the ICC Congress suggested that progressive taxes should be levied only on citizens, without regard to their residence, while flat rate taxes should be imposed on citizens and foreigners in the source jurisdiction.[78] The requirement for nondiscrimination in the tax context was one of the first discussions of this common principle.[79] Following the pressure from the business community, the League of Nations' international financial conference held in Brussels in 1920 declared that double taxation should be handled in such a way as to facilitate cross-border investment.[80] Based on this resolution and following the increasing pressure, the Financial Committee of the League of Nations decided in September 1921 to ask four distinguished economists[81] to prepare a report dealing with the theoretical aspects of international double taxation. The report, published in April 1923, laid out the theoretical principles for taxing cross-border activity, which greatly relied

[71] Part I, Articles 1-26, 387-427 of the Treaty of Versailles.

[72] The International Chamber of Commerce was founded in 1919 in Paris to serve world business by promoting trade, investment, and the free flow of capital.

[73] For example, between 1906 and 1918 in the United Kingdom the income tax rate rose from 5% to 30%. In the United States the federal income tax rate went from 1% in 1913 to 6% in 1918.

[74] Resolution No. 11 of the International Chamber of Commerce in the organizational meeting held in Paris on June 28, 1919; See also Herndon *supra* note 40 at 20; see Graetz & O'Hear, at 1051 for the American perspective.

[75] *Ibid*.

[76] The International Chamber of Commerce Protocol of the London held between June 27 and July 1, 1921.

[77] See Graetz & O'Hear at 1051-1053.

[78] See International Chamber of Commerce Protocol *supra* note 87 at 5.

[79] Article 24 of the OECD Model Tax Convention on Income and on Capital 2005. For a general discussion on the development of the principle see Kees Van Raad, Nondiscrimination in International Tax Law (Series on International Taxation) (Kluwer, 1986).

[80] League of Nations Doc. C. 216, at 5.

[81] Prof. Bruins from the Commercial University, Rotterdam (the Netherlands); Prof. Senator Einaudi from Turin University (Italy); Prof. Seligman from Columbia University (United States); and Sir Josiah Stamp, K.B.E., from London University (United Kingdom). For interesting information regarding the relative contributions of each of these professors to the final report see Graetz & O'Hear text accompanying note 215.

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on the economic allegiance principle.[82] This principle held that the source jurisdiction had the first right to tax income from land and from businesses having a fixed location within the source state jurisdiction,[83] and the residence state had the residual right to tax those types of income and the first right with respect to all other types of income.[84] Regarding ways to prevent double taxation the report suggested four methods. The first two methods were to grant an exclusive taxing power to either the residence or the source jurisdiction.[99] The other two ways were to apportion the taxing rights between the two jurisdictions either according to an agreed formula or according to the various types of income.[85] Finally, the economists expressed their preference for the method which granted the exclusive taxing right to the residence jurisdiction.[8687]

In March 1922 (after the appointment of the four economists but before the publication of the report) the ICC Committee sent a request to the League of Nations urging governments to address the problem of double taxation according to the principles adopted by the London Congress.[102] This was, in fact, the business community asking governments to adopt its guidelines on the issue of international double taxation, and this may have been intended to indirectly influence the results of the Economists' Report. In December 1922 the ICC Committee approved detailed suggestions, along the same lines as the London Congress, to be submitted to the Rome Congress in 1923.[88] The recommendations of the ICC committee included, among other things, the application of a nondiscrimination principle, the understanding that an international agreement for the definition of domicile (residence) should be reached, some understanding as to the limitations on relief from double taxation, and some agreements regarding how income should be sourced.[104] These principles constituted the main lines on which the later model convention of 1928 was based. In March 1923 in Rome (one month before the publication of the Economists' Report), The ICC Congress considered a clear statement of the double taxation issue and ways to approach it. However, no broad agreement could be reached, mainly because of the different views held by the French and Italian delegates, and the matter was returned to the ICC Committee for further discussion.[89] Clashes between capital-importing and capital-exporting states can be observed in the work of the ICC Committee. For example, Italy objected to the approach that taxation on the basis of residence would take precedence over source taxation.[90] Eventually, in March 1924, the ICC Committee reached certain agreements and expressed its preference for adopting bilateral conventions on the issue of international double taxation;

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[82] The Economists' Report *supra* note 3.

[83] The Economists' Report *supra* note 3 at 28-30 and 31-34.

[84] The Economists' Report *supra* note 3 Part II Section II.

[99] The Economists' Report *supra* note 3 at 41-42.

[85] The Economists' Report *supra* note 3 at 42.

[86] The Economists' Report *supra* note 3 at 51. It might be that this preference was expressed due to the lack of adequate representation of capital-importing countries on the committee, See Graetz & O'Hear text accompanying note 225.

[87] International Chamber of Commerce Brochure, at 16-17.

[88] *Ibid*, at 26-28. For a more detailed description of the process, with a special focus on the American Section of the International Chamber of Commerce work led by Prof. Adams, see Graetz & O'Hear at 1093-1097. [104] International Chamber of Commerce Brochure *supra* note 99, pp. 26-28.

[89] *Ibid*, pp. 22, 29-48.

[90] *Ibid* at 9; see also Technical Experts to the Economic and Financial Committee League of Nations Doc. F. 212 at 8; Herndon *supra* note 40 at 33-34.

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provided, however, that a general treaty (multilateral treaty) which would recognize a few definite principles was concluded.[91]

2.1.2 Outside the International Organizations

During the 1920s several bilateral tax treaties were concluded. Some of them distinguished between personal and impersonal taxes. During that time this was not an uncommon distinction.[92] Impersonal taxes are taxes that are levied on a specific type of income regardless of the identity of the taxpayer, while personal taxes are taxes levied on a person, and were usually progressive. The treaties that distinguished between these two types of taxes included the treaties Italy concluded with Czechoslovakia,[93] Germany,[94] and Hungary;[95] and the treaties Hungary concluded with Yugoslavia, Poland, and Germany. The rest of the treaties (around thirteen treaties by the end of the 1920s) did not contain this distinction.[96] The bilateral tax treaties that did not make this distinction were very similar to each other and this might have encouraged the view that a multilateral treaty was achievable at that time. However, an expert who examined this possibility at the time reached the conclusion, similar to the Technical Experts' conclusion in 1928 (described below), that the fiscal laws and interests of each state were so different that it was not possible to merge these bilateral tax treaties into one general multilateral treaty.[97]

On April 6, 1922, representatives from Austria, Hungary, Poland, Romania, and Yugoslavia (the successor states of the old Austro-Hungarian Empire), as well as Italy met in Rome and signed a multilateral tax treaty for the avoidance of double taxation on income and capital.[98] This was the first time a multilateral agreement on double taxation was signed. However, it was ratified only by Italy and Austria and eventually the treaty entered into force four years later as a "regular" bilateral tax treaty between Austria and Italy.[99] It should be noted also that this proposed multilateral treaty followed the method adopted in other bilateral treaties of allocating tax jurisdiction according to the classification of income. This proposed multilateral treaty did not have an adequate solution to the problem of allocating business profits among the signatory countries, and with respect to passive income it required that further agreement be reached by the signatory countries. Thus overall the proposed multilateral treaty did not provide a comprehensive solution and this is probably the reason for the failure of its ratification as a

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[91] International Chamber of Commerce Brochure *supra* note 99 at 7-8 (Section I.5); see Herndon *supra* note 40 at 3031.

[92] See the report of the International Chamber of Commerce Congress meeting in London in 1921 *supra* note 87, Herndon *supra* note 40 at 21-22.

[93] Concluded on March 1, 1924.

[94] Concluded on October 31, 1925.

[95] Concluded on November 25, 1925.

[96] France and the Saar (which joined Germany in 1935) signed on July 5, 1922; United Kingdom and the Irish Free State in 1926; Denmark and Iceland on August 11, 1927; Germany and Czechoslovakia on December 31, 1921; Austria and Czechoslovakia on February 18, 1922; Germany and Austria on May 23, 1922; Hungary and Czechoslovakia on July 13, 1923; Germany and Hungary on November 6, 1923; Danzig and Poland on March 17, 1924; Austria and Hungary on November 8, 1924; Poland and Czechoslovakia April 23, 1925; Austria and Switzerland on October 24, 1927; and Germany and Sweden on April 25, 1928.

[97] See Herndon *supra* note 40 at 261, concluding after a careful analysis of all the relevant tax treaties that such an agreement is not possible. See also the Technical Experts' conclusion *supra* note 103 at 29-31.

[98] Helmut Loukota, Multilateral Tax Treaty Versus Bilateral Treaty Network, in MULTILATERAL TAX TREATIES: NEW DEVELOPMENTS IN INTERNATIONAL TAX LAW 85, 86 (Linde, 1998) (hereinafter Multilateral Tax Treaties).

[99] Bundesgesetzblatt, November 30, 1926. Doc. C. 345, p. 73.

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multilateral treaty.[100] Austria and Italy were more interested than the other states in concluding the multilateral treaty, due to complicated cross-border issues related to the fact that after World War I parts of the population of the former Austro-Hungarian Empire were under Italian dominion.[101] Thus after the other countries realized that the treaty was not an adequate solution for them, it came into effect as a bilateral treaty between Austria and Italy.

2.2 Concluding the First Model Conventions: 1925-1928

Prior to the publication of the Economists' Report in 1923, the League of Nations was asked by the International Economic Conference to consider issues of international tax evasion in addition to that of double taxation.[118] Following this request, the Financial Committee of the League of Nations decided in June 1922 that a committee of technical experts should be appointed to study the practical aspects of double taxation and tax evasion.[102] The committee was appointed and had delegates from several European countries.[103] The committee held several meetings between 1923 and 1925 and in February 1925 it published the Technical Experts Report, which was submitted to the Financial Committee of the League of Nations.[104] The Technical Experts' conclusions are somewhat less important for the purposes of this study as the experts avoided taking an explicit position on the ways to coordinate tax systems.[105] The work of the Technical Experts Committee was dominated by the Italian and French delegates, who preferred to follow the method of allocating taxing rights according to types of income, because that method allowed more leeway to the source state to tax income generated in its jurisdiction.[106][107] Retrospectively, it seems that the Technical Experts Committee's most important recommendation was to suggest that the League of Nations Council invite other technical experts from other states to sit on the committee and allow the enlarged committee to draft a model convention. This suggestion resulted in the addition of a representative from the United States, which effectively weakened the Italian and French dominance.

Meanwhile, following an invitation from the League of Nations, the ICC sent representatives to participate in the League of Nations discussions on double taxation. Taking the focus of this Part to follow the evolution of the bilateral tax treaty network, the next few years of discussions should be viewed and examined in light of the model conventions adopted by the League of Nations in 1928, discussed below.

The ICC Committee gathered in May 1925, representatives from the League of Nations and the International Shipping Conference were present, and the ICC Committee adopted as a recommendation the principle of reciprocal exemption for foreign vessels.[124] The ICC Committee

[100] A. Spitaler, Das Doppelbesteuerungsproblem bei den direkten Steuern, Bad Reichenberg (1936), 284-285.
[101] Mainly in South Tyrol, but also in other areas around Trieste.
[118] See League of Nations Doc. C. 216 p. 5.
[102] See *supra* note 103 at 3.
[103] Belgium, Czechoslovakia, France, United Kingdom, Italy, the Netherlands, and Switzerland. At that time among these countries only the United Kingdom and the Netherlands were net exporters of capital and this, as mentioned above, influenced the committee's conclusions.
[104] See *supra* note 116.
[105] *Ibid*.

[106] The categorization of income was followed by a distinction between personal and impersonal taxes. The source state could impose impersonal taxes on income which was not derived from a business within its jurisdiction.
[107] International Chamber of Commerce Brochure at 9-12.

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also considered the League of Nations Technical Experts Report issued in February 1925. Finally, The ICC Committee drafted resolutions to be submitted before the Brussels ICC Congress, which was held in June 1925; some of these resolutions were a direct response to the League of Nations Technical Experts Report. Eventually, each one of the ICC Committee's resolutions found its way into the model conventions approved by the League of Nations in 1928.[108] Following the proposals in the Technical Experts' model conventions, which were proposed at the London meeting in 1927,[109] the Stockholm ICC Congress adopted a few resolutions.[127] It should be noted that by that time it had become clear that, even though the ICC was the first international organization to put the issue of international double taxation on the international community agenda, and it was urging the League of Nations to take measures to eliminate double taxation, by 1925 the League of Nations had taken the lead in finding ways to handle international double taxation. Being a governmental organization (and taxes are after all levied by governments), the League of Nations was probably the more appropriate organization to take the lead on this matter, and it did so by establishing the Economists' Committee and the Committee of Technical Experts.

Following its own recommendations from 1925, the Technical Experts Committee was expanded and experts from Germany, Poland, Argentina, Venezuela, the United States, and Japan were added to the committee. The American delegation was led by Prof. Thomas S. Adams (who is considered responsible for the revision of the foreign tax credit provision in the Act of 1921),[110] who hoped to limit the extent of source taxation.[111] Another American interest in joining the committee was to try and convince the Technical Experts Committee to prefer the approach of the American Double Taxation Committee of the American Section of the ICC (chaired by Prof. Adams),[112] which was in favor of a multilateral tax treaty instead of a network of many bilateral agreements.[113]

In April 1927 the Technical Experts Committee convened for the eighth time and approved four draft conventions dealing with income taxation, succession duties, administrative assistance, and judicial assistance in collection of taxes.[114] One of the resolutions regarded the bilateral nature of tax treaties: "In the matter of double taxation in particular, the fiscal systems of the various countries are so fundamentally different that it seems at present practically impossible to

[108] Cf. the ICC Committee's resolution from Brochure 34 and the League of Nations model conventions from 1928.

[109] See discussion below of the London meeting of the Technical Experts Committee.

[127] 60 International Chamber of Commerce Brochure, pp. 21-22.

[110] See Graetz & O'Hear, at 1031; see generally Reuven S. Avi-Yonah, All of a Piece Throughout: The Four Ages of U.S. International Taxation, 25 Va. Tax Re. 313.

[111] See Mitchell B. Carroll, "International Tax Law: Benefits for American Investors and Enterprises Abroad," 2 The International Lawyer, 692, 693-694.

[112] See Graetz & O'Hear, 1105.

[113] On the American interests in joining the committee see Herndon *supra* note 40 at 62-65. A reason for opposition to the bilateral treaty network can also be found in the objection of the Secretary of the U.S. Treasury in 1930, who said in a hearing before the House Ways and Means Committee, "The Objection to this method [the bilateral tax treaty method —E.L.] . . . appears to me to be that the concessions are more likely to be based on bargaining than on sound principles of taxation." Hearing before the House Ways and Means Committee on H.R. 10165, A Bill to Reduce International Double Taxation. See also Graetz & O'Hear, at 1081-1082.

[114] Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.216.M.85.1927.II. (1927), reprinted in reprinted in 4 JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS at 4111. [133] *Ibid* at CONVENTIONS LEGISLATIVE HISTORY at 4122.

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draft a collective convention, unless it were worded in such general terms as to be of no practical value."[133] The committee also stated that it had refrained from discussing some questions relating to international law, such as the doctrine of reciprocity and the principle of most-favored nation. It might also be interesting to quote another part of the report which relates directly to this work: "It considers moreover, that the fiscal laws throughout the world will undergo a gradual evolution and that this will, in the future, make it possible to simplify the measures it has recommended and possibly even to unify fiscal legislation."[115]

In 1928 the General Meeting of Government Experts on Double Taxation and Tax Evasion convened in Geneva to discuss the Technical Experts Report from 1927; it approved the four draft models proposed in the Technical Experts Report. The model on direct taxes allowed source states to tax business income owned by non- residents only if derived from a permanent establishment located within the source jurisdiction. The questions of whether a source state could impose tax on passive income and what constitutes a permanent establishment were left open because no broad agreements were reached on these questions.[135]

By that time the practice of concluding bilateral tax treaties was common in Continental Europe. However, by adopting a model convention based on the principle of allocating taxing rights according to different types of income,[116] the League of Nations reinforced this practice. The implication of this choice was the rejection of the other solutions mentioned in the Economists' Report, namely giving the taxing rights exclusively to the residence state or to the source state.[137] Consequently, this choice made it clear that a single multilateral treaty would not be possible at that time. Retroprospectively, it seems that this choice of the 1928 conference (which was the result of a decade of research) set the course of the international tax system for the next decades.[117]

2.3. Considering the Multilateral Option Again: 1928-1931

Based on the recommendation of the Government Experts meeting of 1928, the League of Nations established a Fiscal Committee (the "Fiscal Committee"),[118] which continued the Technical Experts' work. The Committee consisted of a smaller number of delegates and one observer from the ICC.

During its first session, in Geneva in October 1929, the Fiscal Committee identified the issues left open by the General Meeting of Government Experts in 1928. Among the issues the Committee mentioned were: measures to avoid double taxation regarding income derived from patents and authors' rights, rules for the apportionment of profits of enterprises operating in several countries, measures for the avoidance of double taxation of trusts and companies owing large amounts of easily transferable securities, and some clarifications about the definition of

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[115] *Ibid*.

[135] *Ibid*.

[116] General Meeting of Government Experts Report on Double Taxation and Tax Evasion, League of Nations, Doc. C.562. M.178.1928 II, Geneva, October 31, 1928; see also Rosenbloom & Langbein, at 365. [137] See the Economists' Report *supra* note 3 at 41-42.

[117] See Richard J. Vann, A Model Tax Treaty for the Asian-Pacific Region? 45 Bull. Int' l Fisc. Documentation 99 (1991) (linking the current OECD Model to the League of Nations' model of 1928).

[118] Report Presented by the General Meeting of Government Experts *supra* note 133 at 224.

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permanent establishment.[119] Additionally, the Fiscal Committee referred to the views expressed by the meeting of Government Experts (in 1928) and by the Committee of Technical Experts (London 1927), according to which it would be desirable to achieve a multilateral agreement instead of a network of bilateral tax treaties. The Fiscal Committee also referred to the fact that the bilateral solution was adopted because at that time it seemed impossible to reach an agreement regarding a multilateral convention. The business community through the ICC also encouraged governments to adopt a multilateral solution to double taxation.[120] This suggests that the dominant view after the 1928 conference was that even though four different bilateral models were adopted, the bilateral solution was to be considered only temporary, until a broader agreement could be reached. Until 1931, the Fiscal Committee made great efforts to reach such broader agreement but with no significant success (later other topics were placed on the Fiscal Committee's agenda and the efforts to conclude a multilateral convention were abandoned). In its first session's report to the Council, the Fiscal Committee stated that it believed a multilateral agreement could not be reached until a more precise definition of the term "permanent establishment" was determined, and that hopefully such a determination would lead to a multilateral accord in the future.[142] At its second session, held in Geneva between May 22 and May 31, 1930, the Fiscal Committee approved a proposal to adopt a multilateral convention that, although it would not wholly eliminate double taxation, would encourage countries to move toward partial elimination of double taxation according to a uniform law.[121] For this purpose, the Fiscal Committee appointed a subcommittee to submit to the Fiscal Committee at its next session a draft of a multilateral convention.[144] The Fiscal Committee provided the subcommittee with some guidelines to be followed when drafting a multilateral convention. The guidelines included the following: income from annuities, authors' rights, interest on public debt, and wages of workers living on one side of a frontier and working on the other (frontier workers) should be taxed only in the state of residence;[122] income from immovable property should be taxed only in the place where situated; and businesses should be taxed only in the country in which "the real center of management of the company" was situated, unless it had a permanent establishment in another country.[123]

The Fiscal Committee convened again for its third session between May 29 and June 6, 1931, and the topic of achieving a multilateral treaty was high on the agenda.[124] The subcommittee, which consisted of Dr. Damste from the Netherlands (chairman), Dr. Bolaffi from Italy, Mr. Carey from Ireland, and Mr. Clavier from Belgium, submitted to the Fiscal Committee a draft of a multilateral convention designed to eliminate entirely double taxation of cross-border

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[119] See League of Nations Fiscal Committee Report to the Council on the Work of the First Session of the Committee, Geneva, October 17-26, 1929, Doc. C516. M.175.1929 II, p. 3.

[120] The ICC at its congress held in Amsterdam in July 1929 stated: "The International Chamber of Commerce considers that it would be highly desirable for an international conference to be convened as soon as possible. . . for the purpose of unifying as far as possible the systems applied for the abolition of double taxation and preparing a multilateral convention for this purpose." [142] *Supra* note 137, at 12.

[121] League of Nations Fiscal Committee, Report to the Council on the Work of the Second Session of the Committee, League of Nations Doc. C.340.M.140.1930.II, Geneva, 1930, p. 13. [144] *Ibid*. at 14.

[122] *Ibid*.

[123] *Ibid*. Another guideline is that salaries of officials and public employees who are serving abroad, as well as public pensions, would be taxable only in the state which paid such salaries or pensions.

[124] League of Nations Fiscal Committee, Report to the Council on the Work of the Second Session of the Committee, League of Nations Doc. C.415.M.171.1931.II.A.

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transactions.[125] In the preamble to the draft it was stated that the treaty was based on the principle of reciprocity and that it intended to handle double taxation only of persons having their residence in one of the contracting states.[126] It will be useful to describe the methods which this proposed multilateral ("plurilateral" as it is called there) treaty used to eliminate double taxation. The definition of residence under the treaty was, for natural persons, the place of their normal residence, which meant their permanent home, and for legal entities the "real center of management."[127] After the definition article, the proposed treaty provided many rules allocating taxing rights among the relevant jurisdictions. The draft basically took the same approach as the model bilateral treaty from 1928 and allocated taxing rights according to the different types of income.[128] However, unlike the model bilateral treaty, the multilateral treaty adopted a whole-or-nothing approach, meaning that in each case either the source or the residence jurisdiction was granted the right to tax the income, but never both.[129] For example, income from immovable property was subject to tax only in the state where the property was situated.[130] Income of frontier workers was subject to tax only in the country of residence.[154] Authors' rights and income from patents were subject to tax only in the country of residence of the beneficiaries.[131] Income from a business was subject to tax only in the state of residence of the owner, whether a natural person or a legal entity; unless such income was derived from a permanent establishment in the source country, in which case it was subject to tax at source, and to the extent the residence country levied tax on such income, the owner would be entitled to a partial relief.[132] There are some other interesting rules in the draft treaty,[133] but for our purposes it is sufficient at this point to note its overall approach of allocating taxing rights according to the different types of income conferring taxing rights in each case exclusively either to the source or the residence jurisdiction.[134] It might be that it was thought easier to adopt such a whole-or-nothing approach to relieving double taxation on a multilateral basis (rather than allowing both residence and source jurisdictions to tax the same income and then requiring the residence jurisdiction to grant a relief for taxes paid at the source jurisdiction).

The Fiscal Committee made some changes to the subcommittee's draft and both versions of the multilateral treaty were submitted to the Council.[135] The two interesting changes that the Fiscal Committee made were that, first, income derived from a permanent establishment would

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[125] Though instructed to draft a multilateral treaty that would only partially eliminate double taxation, the subcommittee drafted a treaty that was supposed to entirely eliminate double taxation; see the report *ibid* at 3-4, and Draft A in Appendix I to the report.

[126] *Ibid* at 9.

[127] *Ibid* Article 1. No further rule as to how to determine permanent home or real center of management was provided.

[128] *Ibid*.

[129] *Ibid* Articles 2-11.

[130] *Ibid* Article. 2.

[154] *Ibid* Article 7.

[131] *Ibid* Article. 8.

[132] See *Ibid* Articles 4 and 15. It is not clear how if it only granted partial relief this multilateral treaty could claim to wholly eliminate double taxation.

[133] See, e.g., Article 12.

[134] With the exception of the case of permanent establishment, in which the subcommittee draft did not state explicitly that income derived from a permanent establishment would be taxed only in the country in which the permanent establishment was situated.

[135] See *Ibid* p. 6, Appendices I and II.

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be taxed *only* in the permanent establishment jurisdiction[136] (and this fixed the problem noted above);[137] and, secondly, income from employment in "liberal professions" would be taxed only in the state in which they were regularly exercised.[138]

Although the Fiscal Committee was of the opinion that the revised multilateral draft could be used to eliminate double taxation, it also acknowledged that this draft might not be adopted by all countries.[139] The concern was that the multilateral treaty might not be adopted because it required the signatory states to refrain from taxing their own residents with respect to income earned in cross-border transactions.[140] In light of this concern and due to the desire to present a practical solution on a multilateral basis, the Fiscal Committee also provided another version of a multilateral convention based on a different approach.[141] As the Fiscal Committee's main concern was related to the taxation of residents by their home countries, the second multilateral draft was based on the idea of limiting the contracting countries *only* with respect to the taxation of nonresidents.[142] The second multilateral treaty declared that all contracting states reserved the right to tax their residents irrespective of the source state.[143] Then the treaty provided that the signatory countries had the right to tax non-residents on income originating in their territories; however, this right was subject to the exceptions specified in the treaty.[144] Though not specified explicitly as an exception, the non-discrimination principle which was incorporated into the treaty[145] definitely limited the right of the source state in taxing non-residents. Then the treaty went on and identified the exceptions of certain types of income from the tax jurisdiction of the source state.[146] Article 3 listed six exceptions, which included maritime or air-navigation income, business income derived from sources other than a permanent establishment, income from public loans, income earned by frontier workers, income from authors' rights and patents, and income from life annuities.[147] These exceptions entailed the taxation of such types of income only in the state of residence. Comparing the second version of the multilateral treaty to the first suggested draft, it can be noticed that the main differences with respect to the allocation of taxing rights were that in the second draft, unlike in the first, the source state was allowed to tax income derived within its jurisdiction from liberal professions, salaries of officials and public servants, and public pensions.[148] In addition, the residence state was not, in any event, limited in taxing its residents, including with regard to income derived from a permanent establishment and from

[136] See *Ibid* Article 4 in Appendix II to the report.
[137] See *supra* note 155; the fact that according to Article 15 the taxpayer was entitled only to partial relief from the residence country regarding income derived from a permanent establishment might have resulted to a certain extent in unrelieved double taxation. However, if only the source state was allowed to tax income derived from a permanent establishment there would not be any double taxation issue.
[138] See *Ibid* Article 7 in Appendix II to the report.
[139] See *Ibid* p. 6.
[140] *Ibid* p. 6.
[141] See *Ibid* p. 6 and the draft in Appendix III.
[142] See *Ibid* p.6.
[143] *Ibid* Article 1.
[144] See *Ibid* Article .2.
[145] See *Ibid* Article 1 (second paragraph).
[146] See *Ibid* Article 3.
[147] See *Ibid* Article 3 (subsections (a) through (f)).
[148] Compare Appendices II and III.

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immovable property located in the source state.[149] Moreover, the residence state was not obliged to provide any relief for taxes paid to the source government. The Fiscal Committee recognized that the second version of the multilateral treaty eliminated double taxation only to a certain extent;[150] in fact, double taxation would be entirely eliminated only with respect to the types of income that could not be taxed in the source jurisdiction (which were specified in the exception clause). The proponents of the second version believed that countries would sign it in order to secure relief for their residents operating abroad; and that they would consequently also be inclined to provide unilateral relief for taxes paid in the source jurisdiction (even though they were not obliged to do so by the treaty).[175] Thus, the proponents believed that the second version of the multilateral treaty would result in more relief for double taxation than was actually required by the treaty. As mentioned, the second version of the multilateral treaty was based on the notion that countries would be reluctant to change the way they taxed their own residents.[176] It seems that this explanation was based heavily on sovereignty arguments. However, taking revenue interests into account and adopting a source perspective, it is not clear why capitalimporting countries would refrain from taxing foreigners without having at least some assurance that relief for the taxes paid at source would be granted by the residence jurisdictions.[151]

Neither of the aforementioned multilateral treaty versions was ever adopted or even negotiated. Following the third session in 1931 (in which the two multilateral agreements were proposed to the Council), the multilateral option was never again discussed so seriously. The Fiscal Committee fulfilled its responsibility by responding to the views expressed by the Committee of Technical Experts in 1927[152] and in the Government Experts meeting in 1928,[153] as well as to the call made by the business community[154] for a multilateral solution. However, the governments never followed up on the multilateral initiative. It might be that this first proposed multilateral treaty with its whole-or-nothing approach was seen, by both source and residence states, as asking for too much of a sacrifice, because both source and residence states were used to taxing cross-border transactions. On the other hand, the second draft of the multilateral treaty probably was asking too much from capital- importing countries without providing them enough benefits. Also, the fact that by 1931 bilateral treaties were a common tool to eliminate double taxation indicated the enormous complexities of negotiating and reaching an agreement on a multilateral basis. For these reasons the multilateral approach to the issue of double taxation was abandoned.

[149] This is the result of the fact that in Article 1 of the second multilateral draft there are no limits whatsoever on the residence countries.

[150] See the Report to the Council *supra* note 144 at 4-5. [175] *Ibid* at p. 8 [176] *Ibid* at 6.

[151] In the Fiscal Committee were more than a few representatives from capital-importing countries and thus it does not seem that there was any bias against such countries built into the committee's work.

[152] See *supra* the text accompanying note 129.

[153] See *supra* the text accompanying note 133.

[154] See *supra* note 138.

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2.4. Reinforcing the Bilateral Approach: 1933 – 1946

2.4.1. One Last Try for the Multilateral Approach

After the two multilateral drafts of 1931 failed to gain any significant support from governments, the Fiscal Committee tried, in fact for the last time, to advance a multilateral solution. At its next session (the fourth session) held in Geneva between June 15 and 26, 1933, the Fiscal Committee found itself already heavily involved in its next project, which was the issue of profit allocation (an issue that had been left open by the 1928 conference). With a generous grant from the Rockefeller Foundation the Fiscal Committee continued its research on, and drafted a convention regarding, profit allocation.[155] The Fiscal Committee expressed the view that the convention for the allocation of profits could be adopted on either a multilateral or a bilateral basis (or could even be incorporated by countries into their own domestic laws),[156] and that a broad agreement on this issue might form the basis for a broader multilateral convention in the future.[157] Thus, the Fiscal Committee suggested that the Council communicate to governments the convention of profit allocation and inquire about the possibility of entering into a multilateral convention for the issue of profit allocation.[184] During its fifth session, in 1935, the Fiscal Committee decided that because of the low number of countries that had responded positively to the option of negotiating a multilateral convention regarding profit allocation, it would not recommend that the Council call an international conference on the topic.[158] The Fiscal Committee also stated that the fact that most countries were not receptive to the multilateral proposal was not due to any substantive disagreement with the Fiscal Committee's draft; to the contrary, the countries had approved in general the principles laid down in the multilateral draft.[186] The reason for declining the multilateral solution, according to the Fiscal Committee, was that governments considered bilateral agreements to be more appropriate. However, no explanation was provided as to why bilateral agreements were perceived to be more appropriate.[187] The Fiscal Committee also expressed its belief that in the current situation progress was more likely to be achieved by using bilateral means, and therefore the convention for profit allocation should be negotiated and advanced on a bilateral basis. The Fiscal Committee was of the opinion that developing a broad agreement on the subject through bilateral agreements might contribute in the long run to the coherence of the international tax system and enable the conclusion of a multilateral treaty in the future.[159] In its next report to the Council, the Fiscal Committee stated that the new clauses regarding profit allocation that had been drafted[160] should be communicated to governments together with a note that these clauses could be used in either a bilateral or multilateral agreement.[161]

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[155] League of Nations Fiscal Committee, Report to the Council on the Work of the Second Session of the Committee, League of Nations Doc. C.399.M.204.1933.II.A, Geneva, 1933.

[156] *Ibid* at 2.

[157] *Ibid* at 4.

[184] *Ibid* at 5.

[158] League of Nations Fiscal Committee, Report to the Council on the Fifth Session of the Committee, League of Nations Doc. C.252.M.124.1935.II.A. , Geneva, 1935, p. 3. [186] *Ibid* at 3-4. [187] *Ibid*.

[159] *Ibid* at 4.

[160] New clauses regarding allocation of profits of insurance enterprises, and the allocation of taxes on property, capital, or income of such international enterprises.

[161] League of Nations Fiscal Committee, Work of the Fiscal Committee during Its Sixth Session, League of Nations Doc. C.450.M.266.1936.II.A., Geneva, 1936, p. 10.

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After this attempt, the Fiscal Committee gave up on any further efforts to advance the notion of alleviating double taxation on a multilateral basis. It seems that the rejection of the two multilateral drafts of 1931, and the implicit negative response to the Fiscal Committee's suggestion to negotiate the convention for allocation of business income on a multilateral basis, determined that it would be the fate of the international tax system to be dominated by bilateral agreements. As mentioned above, governments in their response to the Fiscal Committee's proposal did not provide an explanation as to why bilateral agreements were considered to be more appropriate, but a reasonable guess might be that the powerful states preferred bilateral negotiations in which they had a better bargaining position and better chances to reach an agreement that suited their fiscal interests.

2.4.2. The Last Contribution of the League of Nations: 1936-1946

After the publication of the report on the allocation of business income[162] and the publication in 1935 of the model convention regarding business income,[163] the Fiscal Committee abandoned the option of advancing solutions on a multilateral basis. During the next few years, the Fiscal Committee was mainly engaged with the issue of tax evasion, some more general topics like the evolution of fiscal systems, and the general study of principles of taxation.[164] In 1939 the Second World War broke out. Nonetheless, the Fiscal Committee's work was continued during the war through a subcommittee, which met at the Hague in April 1940, and was succeeded by two regional tax conferences held in Mexico City in June 1940 and July 1943. The regional conferences in Mexico also included several Latin American countries, which the United States thought would be interested in industrial and business expansion after the war.[165] These meetings were dominated by capital-importing countries (the Latin American countries and Canada). Eventually, these meetings resulted in a new draft of a bilateral double tax treaty (usually referred to as the Mexico draft)[166] along the lines of the previous League of Nations drafts from 1928 but aimed at strengthening source taxation.[167] After World War II, the Fiscal Committee convened for its tenth session in London on March 20-26, 1946 and published a new draft[168] that amended the Mexico draft and was designed to move the balance towards residence-based taxation.[169] The Fiscal

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[162] Mitchell B. Carroll, Taxation of Foreign and National Enterprises, Volume 4: Methods of Allocating Taxable Income, League of Nations (the Carroll Report).

[163] *Supra* note 182.

[164] See generally the Fiscal Committee report *supra* note 187; League of Nations Fiscal Committee, Report to the Council on the Fifth Session of the Committee, League of Nations Doc. C.490.M.331.1937.II.A, Geneva, 1937; and League of Nations Fiscal Committee, Report to the Council on the Ninth Session of the Committee, League of Nations Doc. C.181.M.110.1939.II.A. Geneva, 1939.

[165] See Carroll *supra* note 136 at 707.

[166] League of Nations Doc. C.2.M.2.1945.H.A. Fiscal Committee, Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion. Second Regional Tax Conference, Mexico, D.F., July 1943, Geneva, 1945.

[167] The Mexico draft determined the primacy of the source jurisdiction. Business income derived from a permanent establishment would be taxed *only* in the source country, while payments of interest royalties and dividends could be taxed in the source jurisdiction as well. Countries were allowed to tax their residents' worldwide income but were obliged to grant credit for the foreign tax paid in the source country.

[168] League of Nations Fiscal Committee, Report on the Work of the Tenth Session of the Committee. League of Nations Doc. C.37.M.37.1946.II.A, London 1946.

[169] The London draft reaffirmed the League of Nations' prewar draft according to which the source jurisdiction's taxing right was limited to income derived from a permanent establishment. It is interesting to note that both drafts used the same definition for permanent establishment.

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Committee, instead of combining these two drafts or adopting one of them, published both together with a commentary.[170] This act underlined once again the tension between source and residence countries. The publication of the London and Mexico drafts were the last contributions of the Fiscal Committee to the international tax field; thereafter, the League of Nations was replaced by the United Nations (UN).[171] Although the United Nation's Economic and Social Council set up a Financial and Fiscal Committee, which planned to continue the League of Nations Fiscal Committee's work,[172] no further progress was made. This was mainly because of the politicization of the debate due to the broad membership in the organization, which included developing countries and states from the Soviet bloc.[173]

On another front, following pressure from the business community regarding the need for a tax treaty with the United States, and pressure from the British Foreign Office, which was concerned with shaping the liberalized postwar world economy, the British Treasury eventually agreed to implement a foreign tax credit regime in the United Kingdom.[174] Moreover, it agreed to consider the option of a tax treaty based on a foreign tax credit. This paved the way for the American and British governments to negotiate a bilateral treaty.[175] The US-UK treaty concluded in 1945 (before the publication of the London draft) brought into alignment the two powers which dominated the postwar international trade and investment field and was thus a significant step in the development of the bilateral tax treaty network. The content of the treaty was close to the London draft, according to which the source country was entitled to tax business income derived from a permanent establishment and had only a limited right to tax investment income, while the residence state was obliged to credit the tax paid to the source government.[176] The fact that these two powers adopted a bilateral treaty seemed to prove that the bilateral treaty was the preferable way for governments to coordinate taxation of cross-border transactions. This treaty was the opening shot in the postwar era for the enormous growth in the number of bilateral tax treaties. In a way, this meant the loss of an opportunity for the international community to use the post-World War II atmosphere to reshape the international tax regime and maybe to conclude a multilateral tax treaty, as was done in the trade area.[177]

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[170] League of Nations Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text. League of Nations Doc. C.88.M.88.1946.II.A., Geneva, November 1946.
[171] The League of Nations ceased to exist after World War II and the United Nations was founded in its place on October 24, 1945.
[172] See Picciotto *supra* note 77 at 51.
[173] See Picciotto *supra* note 77 at 50-51; and Vann *supra* note 135, at 103.

[174] The 1945 Finance Act (No. 2). This foreign tax credit was on a country-by-country basis.
[175] See Sir Cornelius Gregg, Double Taxation, 33 Grotius Society Transactions, 77 (1947).
[176] The income tax convention between the United States and the United Kingdom of Great Britain and Northern Ireland, signed April 16, 1945, and Supplementary Protocol, signed on June 6, 1946; effective (for the purposes of United States income and excess profits taxes) for the taxable years beginning on or after January 1, 1945.
[177] The income tax convention between the United States and the United Kingdom of Great Britain and Northern Ireland, signed April 16, 1945, and Supplementary Protocol, signed on June 6, 1946; effective (for the purposes of United States income and excess profits taxes) for the taxable years beginning on or after January 1, 1945. [207] Basically, the developing-developed divide, the East-West political tension, and also to some extent, the gap between Anglo-Saxon and Continental European countries. For a description of the UN Fiscal Committee meetings in 1951 and 1953 see Carroll Report on the Meeting of the UN Fiscal Commission, Lake Success, Fifth Bulletin for International Fiscal Documentation, 7; and Carroll Action on Tax Treatment of Foreign Income at session of UN Fiscal Commission, Seventh Bulletin for International Fiscal Documentation 183.

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3. Post-World War II Developments

3.1. The Developed Countries Club: 1946-1963

As mentioned above, the Financial and Fiscal Committee of the UN could not make any progress in the international tax field, mainly because of unbridgeable gaps between its many members.[207] On the other hand, the Organization for European Economic Cooperation (OEEC), which was established in 1948,[178] had a relatively narrow membership, consisting mainly of developed countries with interests in common.

During the 1950's, as result of the inability of the Financial and Fiscal Committee of the UN to deal with double international taxation, the business community, through the ICC, began to urge the OEEC and governments to deal with this issue. In 1954, the Executive Committee of the ICC adopted a resolution urging the Council of the OEEC to recommend that as soon as possible all OEEC governments (i) conclude bilateral tax treaties for the avoidance of double taxation based on the London draft; and (ii) adopt unilateral measures under domestic laws in order to eliminate double taxation. The ICC also expressed its belief that it would be desirable for the OEEC to engage in a study as to the possibility of concluding a multilateral treaty on double taxation among OEEC countries; and, were the possibility found to be practical, the ICC asserted, a multilateral approach has a great advantage in promoting uniformity in the area.[179] In its response to the ICC, the OEEC did not explicitly respond to the call for a study on the possibility of concluding a multilateral tax treaty. The OEEC expressed the view that methods for eliminating double taxation could be implemented on a unilateral, bilateral or multilateral basis, and then noted that the goal of the ICC was urging the OEEC to realize one of these methods of eliminate double taxation. The OEEC pointed out that the process of eliminating double taxation among countries with different legal and fiscal systems is a complicated process that takes time. Furthermore, it noted that even the London draft (to which the ICC had referred) was, and still is, subject to objections by several countries, and that in light of other efforts being made in the field of international taxation by the UN, the OEEC could not achieve any further progress in this area at that time. Based on the OEEC response and the lack of response to the call for a study on the possibility of a multilateral tax treaty, it can be inferred that the OEEC did not view the multilateral option as feasible, mainly because of differences among the various fiscal and legal systems, and due to the fact that countries had already concluded bilateral tax treaties amongst themselves. In a letter to the OEEC dated March 24, 1955, the Secretary General of the ICC noted that the query regarding a multilateral treaty was merely a suggestion, and that the ICC was aware of the difficulties in the way of achieving a multilateral accord.[180] In connection with suggestions regarding indirect taxes, the Swiss delegation expressed its view, that because of the complexity of national tax laws, and the legal, financial, and technical difficulties, the solution of a multilateral treaty had not thus far seemed possible, and consequently, Switzerland preferred to conclude bilateral tax treaties.[181] In December 1955, the Netherlands, Switzerland, and Germany suggested that the OEEC establish a group of experts on the issue of double international taxation in

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[178] The OEEC was founded in 1948 in order to administer the Marshal Plan and to bring to economic recovery to Europe after World War II.

[179] See the Council of the OEEC, Double Taxation in Europe, Resolution Adopted by The Executive Committee of The International Chamber Of Commerce, C(54)294 citing the ICC letter.

[180] Council of the OEEC, Letter From The International Chamber of Commerce Relating to The Recommendation of The Council Concerning Double Taxation, C(55)37(Final).

[181] Council of the OEEC, C(55)88.

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order to advance the study in this field.[182] Their proposal also advanced that this group of experts should consider whether the multilateral option was possible.[183] Following this suggestion, and given the fact that the Fiscal Commission of the UN had been dissolved without its tasks being transferred to another body, together with continuing pressure from the business community, the Council of the OEEC resolved, on January 13, 1956, to establish an ad hoc group of experts.[184] Based on reports from the group of experts to the OEEC regarding issues it should consider, it was decided the issue of a multilateral treaty would be left for future study and consideration.

In conjunction with its panel of experts, the OEEC, through its Fiscal Committee, basically continued the League of Nations' work from where it had ceased at the London draft, published in 1946.[185] Eventually, the OEEC Fiscal Committee responded to the ICC call to explore ways of reaching a multilateral convention, and in its first report (May 1958), stated its belief that the current best way to advance tax coordination was by promoting greater uniformity among bilateral tax treaties; and that this could, in the long run, be the basis for establishing a multilateral treaty.[186] The OEEC Fiscal Committee expressed the same views again in its second report, in July 1959;[187] its third report, in 1960;[188] and its fourth report, in 1961.[189]

In 1961, the OEEC became the Organization for Economic Co-operation and Development (OECD), and in 1963 it published its first draft of a model for a double tax convention on income and capital, together with a commentary.[190] In its report to the Council of the OECD, the Fiscal Committee discussed at length the option of a multilateral tax treaty. The committee again expressed the view that because of the number of outstanding issues, reaching a broad agreement on a multilateral basis was not feasible.[191] It suggested, however, that it might be feasible to reach a multilateral regional accord among specific groups of member countries. It also expressed the hope that such a multilateral treaty could be achieved among member countries of the European Economic Community.[192] The Fiscal Committee also noted that ministers of the

[182] Council of the OEEC, Double Taxation Memorandum by The Delegations for The Netherlands Switzerland and Germany, C(55)307.

[183] *Ibid*. at 3.

[184] Council of the OEEC, Council Resolution, C(56)1.

[185] Being an organization that mostly represented the developed countries' interests, it was only natural that the OEEC's starting point was the London draft, which tended toward a residence- based tax, rather than the Mexico draft. See Van den Tempel, Relief from Double Taxation (1967), for the determination that the OECD model followed the London draft more than the Mexico draft. See also Vann *supra* note 135, at 103 footnote 15 for pointing out the long delay (from 1946 to 1956, when the OEEC eventually continued the League of Nations Fiscal Committee's work) in the evolution of the tax treaty system.

[186] See the OEEC first report: Legislative History of United States Tax Conventions, Volume 4, Section 2: Organization for European Economic Cooperation (OEEC) ¶ 13, 23.

[187] See Legislative History of United States Tax Conventions, Volume 4, Section 2: Organization for European Economic Cooperation (OEEC), The Elimination of Double Taxation: Second Report by the Fiscal Committee of the OEEC, July 1959, ¶ 14.

[188] See Legislative History of United States Tax Conventions, Volume 4, Section 2: Organization for European Economic Cooperation (OEEC), The Elimination of Double Taxation: Third Report by the Fiscal Committee of the OEEC, 1960, ¶ 3 and 9.

[189] Legislative History of United States Tax Conventions, Volume 4, Section 2: Organization for European Economic Cooperation (OEEC), The Elimination of Double Taxation: Fourth Report of the Fiscal Committee, 1961, ¶ 33.

[190] Report of the OECD Fiscal Committee, Draft Double Taxation Convention on Income and Capital (OECD, 1963).

[191] Report of The Fiscal Committee on the Draft Convention for The Avoidance of Double Taxation with Respect to Taxes on Income and Capital among The Member Countries of the OECD, C(63)87 Part I at paragraph 61.

[192] *Ibid*. at paragraph 58.

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member states of the European Free Trade Association had agreed that it would be desirable to remove double taxation impediments via a multilateral agreement.[193] In its conclusion to the report, the Fiscal Committee proposed that the Council instruct the committee to report to the Council when and if the approach to international double taxation might be based on a multilateral agreement among OECD countries.[224]

After the foundation of the OECD and the publication of the 1963 model convention with its accompanying commentary, bilateral tax treaties became virtually the sole device for coordinating national tax systems.[194] The OECD itself was and still is of the opinion that a multilateral tax treaty (although desirable) is not a feasible way of eliminating double taxation, and that countries should therefore adhere to the bilateral system.[195]

3.2. Multilateral Efforts Following the OECD Model Tax Treaty of 1963

In 1968, the European Economic Community (EEC) prepared the draft of a multilateral convention for double taxation[196] but it was too general, and the project never matured into anything practical. The European Free Trade Association (EFTA) also tried to advance a multilateral treaty, but following the EEC's experience, it abandoned the project in 1969, under the impression that tax systems were too different to be dealt with on a multilateral basis.[228] However, leaving aside mutual assistance and arbitration agreements, a few multilateral treaties have emerged on a regional basis in the last few decades. In South America, the Andean countries of Bolivia, Chile (which withdrew later), Colombia, Ecuador, and Peru signed in November 1971(Venezuela joined the treaty later) a multilateral tax treaty which eliminated double taxation by adhering to the source principle.[197] The Nordic countries picked up on the EFTA project abandoned in 1969, and in March 1983, Denmark,[198] Finland, Iceland, Norway, and Sweden signed a multilateral tax treaty, replaced with new treaties in 1987, 1989, and the current version, signed in 1996.[199] To a certain extent the Nordic treaty operates more like a network of bilateral treaties than a multilateral treaty.[232] In July 1994, eight countries of the Caribbean Community signed a multilateral tax treaty which, similar to the Andean treaty, deals with double taxation by adopting the primacy of source taxation.[200] These regional multilateral agreements will be discussed more extensively in chapters to follow, but it should be noted that these agreements are still the exception. The failure of the EEC and the EFTA to conclude a general multilateral tax treaty shows once again that governments prefer the bilateral method, even within free trade zones.

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[193] *Ibid*. at paragraph 59.

[224] *Ibid*. at paragraph 64.

[194] Among the few exceptions are the Nordic multilateral treaty, the Andean multilateral treaty, and the Caribbean multilateral treaty; see below, Section 7.2.

[195] Nevertheless, the OECD encouraged countries to reach multilateral treaties on a regional basis in cases where national tax systems had similarities that would enable them to reach such an agreement; see OECD, 1963 and 1977. See also Vann *supra* note 135 (regarding the unfeasibility of reaching a multilateral treaty).

[196] See Multilateral Tax Treaties, *supra* note 111, at 86.

[228] See Multilateral Tax Treaties, *supra* note 111, at 86.

[197] The treaty is reproduced herein in Annex I. See also A. Atchabahian, Fiscal Harmonization in the Andean Countries (Amsterdam), 1975.

[198] The local government of the Faroe islands joined Denmark as a signatory of its own in 1996.

[199] The treaty is reproduced herein in Annex II. For a translation of the 1983 treaty, see H. Hamaekes, Multilateral Instruments on the Avoidance of Double Taxation, 40 Bulletin for Fiscal Documentation (February 1986), 99; For the 1989 treaty see 44 Bulletin for Fiscal Documentation (August 1990), 438. [232] See Vann *supra* note *135* p. 151.

[200] The treaty is reproduced herein in Annex III.

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Moreover, even in the European Union (which nowadays is more than a free trade area) a multilateral tax treaty is still far from being achieved.[201][202]

4. What Can We Learn from the Past

The issue of double income taxation emerged in the nineteenth century in several distinct contexts. In the last quarter of the nineteenth century, states started to use bilateral tax treaties to coordinate their tax systems and eliminate double taxation. From the outset the two main principles around which such coordination evolved were that persons should be subject to income tax in the place of their domicile and that businesses and real properties should be subject to tax in the place of their location. By 1914 there were about twenty bilateral tax treaties among Continental European states and all these treaties were dominated by these two principles.[203] The Economists' Report that was published in 1923 reinforced these principles with its economic allegiance analysis. When the Technical Experts Committee chose to adhere to these principles it reflected the common practice of classification and assignment of taxing rights.[204] During the first half of the 1930s the multilateral option was discussed extensively but with no practical results. From then on, the bilateral approach just became more and more common and with the failure of the international community to reshape the international tax system after World War II, the multilateral approach started to be viewed as impractical.

When the Technical Experts Committee concluded during the late 1920s that a multilateral treaty was not practical to achieve, it may be that the committee could have facilitated a future multilateral treaty by recommending the practice of granting exclusive taxing rights (in each case either to the source state or the residence state).

By not doing so, the Technical Experts Committee may have unintentionally imposed a significant obstacle to the achievement of such a multilateral treaty in the future. If taxing rights with respect to cross-border transactions were allocated among states on an exclusive basis (i.e., so that with respect to each type of income either the source state or the residence state would have the exclusive right to impose tax), then it might have been easier to conclude a multilateral treaty. This is because, unlike the current practice, which grants the residence jurisdiction the residual right to tax income derived in the source jurisdiction, the tax revenues of the residence jurisdiction would not be directly affected by the tax imposed by the source government. However, such a practice of granting exclusive taxing rights was not introduced, and tax revenues of capital-exporting states continue to be directly affected by the extent of taxation in the source jurisdiction. This situation in fact perpetuates the desire of powerful states to have a network of bilateral tax treaties (which allows them to maximize their bargaining positions when negotiating tax treaties).

It seems that the two main reasons for rejecting the multilateral solution over the years have been, first, that the tax and fiscal systems of the various states were so different that a multilateral coordination was considered impossible to achieve, and second, that the interests of

[201] There are no direct clauses about income tax in the EU treaties; the European Court of Justice cases on income tax are all about discrimination and ensuring the exercise of the four freedoms. For the rejection of the notion of replacing the bilateral tax treaties with a multilateral treaty, see EC Court of Justice, 5 July 2005, Case C-376/03 D. v. Inspecteur van de Belastingdienst, ¶ 60-61; available also in MATERIALS ON INTERNATIONAL & EC TAX LAW, Kees Van Raad (ed.) (OECD, 2006) p.

[202] , 2550-2551.

[203] See above Section 1.2.3.

[204] See above Section 2.1.1.

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the most influential states were (and still are) to preserve the bilateral system, which allows them to maximize their bargaining positions when negotiating tax treaties.

Tax systems today have more in common than they did in the 1920s, and, more importantly, most states today use very similar regimes in their domestic tax laws and very similar arrangements in tax treaties in order to coordinate their tax systems (basically along the lines of the OECD model). In this respect it seems that the world has reached the stage at which the Technical Experts Committee thought a multilateral treaty would be achievable: "fiscal laws throughout the world will undergo a gradual evolution and . . . this will, in the future, make it possible to simplify the measures it has recommended and possibly even to unify fiscal legislation."[205] Thus, it seems that the main obstacle to reaching a multilateral treaty is the wish of countries to negotiate tax arrangements on a bilateral basis in order to take into account in the best way their fiscal interests based on the capital flows into and from the relevant jurisdictions.

2. The Development of the Bilateral ITR, 1963-2013[206]

In the fifty years between the first OECD model (1963) and the beginning of the BEPS process (2013), the ITR was dominated by bilateral treaties (DTTs) based on either the OECD model or the UN model (from 1980). Over time, the two models became more like each other. Therefore, as Elliott Ash and Omri Marian have shown, by 2019 80% of the words of each of the over 3,000 bilateral tax treaties were identical, with all the negotiations focused on the other 20%.[207]

There is an extensive literature on DTTs, which we will only summarize here. DTTs are generally entitled "Convention Between [Country X] and [Country Y] for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income." This title provides us with quite a bit of information. First, DTTs are bilateral: They represent a bargain between two countries, like BITs but unlike other economic law treaties, such as the GATT. Moreover, unlike the BITs, DTTs generally do not contain a Most Favored Nation (MFN) article, which means that their provisions cannot be transferred to third countries.
Second, the title states that the DTT, like all DTTs, is for the "Avoidance of Double Taxation and the Prevention of Fiscal Evasion." In truth, DTTs are generally not necessary to prevent double taxation, although they may help in borderline situations, such as cases where the source of income is disputed. This is because almost all countries prevent double taxation (i.e., taxation by both the residence and source country) unilaterally by having the residence country either grant an exemption to foreign source income or grant a foreign tax credit for source country tax on that income. Since these provisions apply unilaterally without a DTT, DTTs are generally not needed to prevent double taxation.

If DTTs do not address double taxation, what do they do? DTTs shift tax revenue from source countries to residence countries, because under the generally accepted rules, the source country is allowed to impose the first tax on any revenue deriving from sources within it. In the

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[205] See above Section 2.2.

[206] This part is based on Avi-Yonah, Reuven S., Double Tax Treaties: An Introduction (December 3, 2007). Available at SSRN: https://ssrn.com/abstract=1048441 or http://dx.doi.org/10.2139/ssrn.1048441.

[207] Ash, Elliott and Marian, Omri Y., The Making of International Tax Law: Empirical Evidence from Natural Language Processing (January 11, 2019). UC Irvine School of Law Research Paper No. 2019-02, Available at SSRN: https://ssrn.com/abstract=3314310.

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absence of a DTT, source countries can tax both active and passive income within the country. In addition, source countries are not bound by a permanent establishment or DTT sourcing rule defining what income originates within the country.

DTTs shift the burden of taxation from source to residence country in two ways.

The main mechanism for active income is the definition of *permanent establishment*. DTTs generally bar source-based taxation unless an enterprise of the other state has a permanent establishment, i.e., some kind of fixed base of operations directly or through a dependent agent, in the source country. The main mechanism for passive income is a reduction in withholding its source. The U.S. model DTT, for example, reduces taxation on interest and royalties to zero; the only category of passive income that is eligible for source-based taxation is dividends, which are taxed at a reduced rate. The OECD model DTT, which is the main model for developed countries, reduces tax on royalties to zero but has a positive rate on interest and dividends. The UN model DTT, which is the main model for developing countries, leaves the specific rates to bilateral negotiations, and this is the better approach because of the differences in country interests and direction of investment flows.

This DTT structure works well if the flows of income are reciprocal but creates a problem for developing countries. In the reciprocal situation, residents of country A derive income from sources from country B and residents of country B derive income from sources of income from country A. In the absence of the DTT, country A will tax the country B residents' source income and country B will tax the country A residents' source income; both countries A and B will probably grant a tax credit or exemption to alleviate double taxation and encourage cross-border investment. The DTT shifts the taxation of some categories of income, particularly passive income, from the source to the residence country. Under the DTT, country B will not tax passive income that goes to country A residents and country A will not tax passive income that goes to country B residents. If the capital flows are more or less reciprocal, the DTT reduces the administrative burden of imposing withholding taxes, and the net revenue is more or less the same. The amount that country A loses by not imposing its withholding tax is regained by not having to give credit for the taxes imposed by country B on income its own residents earn overseas.

If the investment flow only goes one way, and investment always flows from country B into country A, then it is much harder to get into a DTT because a DTT will always transfer revenue from country A to country B. Thus developing countries have traditionally not chosen to enter into DTTs with developed countries because the DTTs lead to a loss of tax revenue. Some developed countries such as Germany, Sweden, and Japan have historically had extensive DTT networks with developing countries because they were willing to provide tax-sparing credits (credits for taxes that would have been collected at source but for a tax holiday), but the United States, which refuses to grant tax sparing in its DTTs, had few DTTs with developing countries until the 1990s, although the situation has changed somewhat in recent years. One reason for the recent expansion in US DTTs with developing countries is that the DTT provides certainty for American investors regarding the tax law of the other country, and most developing countries consider it to their benefit to encourage American investment. Another reason is that DTTs generally include an exchange-of-information provision that allows the developing country to obtain information exchanged from the United States and developing countries have increasingly been interested in trying to tax capital invested by their rich residents overseas.

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Since the OECD model is the source of most DTTs, we shall focus on it and compare it to the UN and US models. One such difference is that the U.S. model DTT, but not the OECD or UN models, "shall not restrict in any manner any benefits now or hereafter accorded by the laws of either contracting state." In other words, from the American perspective, DTTs may never increase taxation, but may only reduce the taxation that would otherwise apply. One reason for this is that tax laws are passed by Congress as a whole, whereas DTTs are ratified only by the Senate. A tax increase through a DTT would be unconstitutional because it would never have been ratified by the House of Representatives. A related point is that the United States only allows DTTs to reduce foreign taxation of Americans and American taxation of foreigners; DTTs cannot affect the way the United States taxes American residents. This provision is written into the savings clause, appearing in most American tax DTTs at the end of the first article. The savings clause also states that people who have lost their citizenship for tax-motivated reasons should be treated as if there were no DTT, because the United States argues that DTTs are not designed to protect Americans from American tax.

Article 2 of the DTT states that the taxes covered in the DTT are only income taxes. For example, in US DTTs the social security tax, which is a payroll tax, is generally excluded and sometimes is covered by other agreements. Estate and gift taxes are also covered by other agreements. The DTT thus has the largest effect on the imposition of the income tax. Importantly, US DTTs do not generally protect against any type of state tax (although in the OECD and UN models, sub-federal income taxes are covered). Most states have corporate and individual income taxes, which may impose a high burden. For example, a foreign company might wish to open an office in New York City to engage in preparatory and auxiliary activities, which is exempt from federal taxation by the permanent establishment article. However, the combined New York state and New York City corporate income tax can be as high at 20 percent, imposing a significant tax burden on the company.

Article 4 covers residence and is important because it defines who is covered by the DTT. In general, groups covered by the DTT are tax residents (i.e., people considered resident for tax purposes, which generally requires physical presence over 183 days); tie- breaking rules are included to prevent dual-residency situations. Corporations are deemed to be residents in the country in which they are incorporated (the US position) or in the country in which they are managed and controlled (the UK position).

Next we turn to a discussion of the substantive provisions. Article 5 covers permanent establishment. This provision is quite narrow in scope; in the OECD and US models the permanent establishment threshold is set high because they are for developed countries interested in reducing source-based taxation of capital-exporting enterprises.

Thus in the OECD and US models a construction facility or an oil drilling facility must be in the country for more than twelve months to be taxed, but in the UN model only for six months. The OECD and US article also includes a long list of exceptions and a specific bar against force-ofattraction rules (such as found in the UN model) in which income is taxed when there is a permanent establishment even though it is not attributable to the permanent establishment.

Article 6 covers real property; taxation of real property at source is allowed, including, as under the American rule, corporations most of whose assets are real property. Article 7 is the business profit article, which talks about taxation of business profits only if they are connected to a permanent establishment; Article 9 is the associated enterprise article, which says that if there is a transfer pricing adjustment and the other country agrees to it, then the other country shall make a corresponding adjustment to prevent double taxation – but notice that the other country

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must agree. Many transfer pricing adjustments unfortunately are not agreed to by the other country and result in double taxation (source-source double taxation), so this article is of only a little help.

The subsequent articles reduce source-based taxation on passive income, dividends, interest, royalties, and capital gains. These articles are the heart of the DTT, whose main function (as explained above) is to reduce source-based taxation of passive income. Under the American model, the only source-based taxation that is allowed is the tax on dividends; there is no tax at all on interest, royalties, or capital gains. The OECD model, by contrast, permits tax on interest. Under the U.S. model DTT, a tax of 5 percent is allowed on direct dividends (dividends to corporations who own a high percentage of the shares) and 15 percent for portfolio dividends, but recent US DTTs reduce the tax on direct dividends to zero.

The next articles address independent services and other special topics. Article 22 of the US model covers limitation of benefits and is a major element in modern American DTTs. The limitation-of-benefits article is designed to prevent treaty-shopping such as the SDI case, in which copyrighted software located in Bermuda was licensed to the Netherlands and from there licensed to the United States, and royalties were paid from the United States to the Netherlands and from the Netherlands to Bermuda. This was beneficial to the company, because the Netherlands has a DTT with the United States that reduces taxation of the royalties to zero and Bermuda (a tax haven) does not. In that case, the IRS argued that although the royalties from the Netherlands to the United States were protected by the DTT, the royalties from the Netherlands to Bermuda were also U.S.- source royalties because of the software's use in the United States. However, the court rejected that argument, saying that if it permitted the taxation of the Netherlands- Bermuda royalties it would be allowing double taxation if the US-Netherlands royalties were not protected by DTT. This seems like a strange argument, because the treaty-shopping occurred only because of the DTT, so that there would be no US-Netherlands royalties if the DTT did not exist.

Most U.S. DTTs did not have elaborate anti–treaty-shopping mechanisms before the 1980s, and other countries were able to use those DTTs to get reduced withholding taxation. Consider the example of the Netherlands Antilles, a Caribbean tax haven that used to belong to the Netherlands. Before the enactment of the portfolio interest exemption in 1984, American companies established Netherlands Antilles subsidiaries and were subject to a zero withholding tax on interest from those subsidiaries through the U.S.-Netherlands DTT. In 1984, the United States terminated the extension of the DTT to the Netherlands Antilles and enacted a portfolio interest exemption; at the same time, it instituted a limitation of benefits. These limitation-ofbenefits articles in US DTTs are often much more complicated than the model version because other countries want to create loopholes to allow for treaty-shopping. In addition, the OECD and UN models do not contain limitation on benefits, although the commentary on Art. 1 of the OECD model has a model limitation on benefits article.

Limitation-of-benefits provisions state that the DTT confers benefits only on individuals who are physically present in the other DTT country and companies that either are publicly traded on a stock exchange of the other country or are privately owned companies that do not pay half or more of their income to a resident of a non-treaty country. The US model DTT thus takes the view that reductions in source income taxation should be accompanied by increases in residence income taxation. For example, the residence article states that if an entity is fiscally transparent in the residence country and is a partnership not subject to residence-based taxation, the entity really belongs to a group of people in another country and is therefore not considered a resident.

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Thus the DTT attempts to reduce taxation at the source only if taxation increases on a residence basis, although it is unclear that the limitation-on-benefits provisions really achieve this purpose.

The US model DTT also includes an earning stripping provision that prevents the deduction of too much interest from the United States. Note, however, that the provision applies to interest but not to royalties; companies may therefore strip earnings through royalties without penalty. The OECD and UN models do not include this provision.

The United States is probably correct in insisting on limitation of benefits, although other countries certainly do not agree that they need to abide by the American position. Without limitation of benefits, non–treaty countries have less incentive to negotiate, because they have a so-called “treaty with the world”, meaning that they can always benefit from other countries' DTTs by entering the DTT network through another country.

Article 24 contains a nondiscrimination provision stating that countries may not discriminate against residents of the other country. This provision is weak compared to similar provisions in the GATT and the BITs, and is hard to enforce. Article 25 is the competent authority procedure for mutual agreement, which provides for some (generally nonbinding) arbitration in cases where the DTT lacks binding force. The OECD model now contains a binding arbitration provision designed to prevent double taxation, and some new US DTTs include a similar provision. Note, however, that no DTT provides for binding arbitration at the request of the taxpayer, like the BITs and NAFTA.

The last important component of the model DTT is the exchange-of-information provision, which is found in Article 26. The United States and most other OECD countries believe that this provision is essential if it is to enforce residence-based taxation on its own residents. The United States has been willing to forego the ratification of a DTT rather than ignore this provision. For example, the U.S.-Israel DTT was delayed for almost twenty years because the Israelis were not willing to give sufficient written assurance of cooperation in exchange-of-information requests. The exchange-of- information provision raises important privacy questions: is it necessary to make a specific request for specific information about a specific resident, or is it possible to request information about a group of residents without including names? In addition, bank secrecy provisions mean that often a government might not have the information requested. In addition, no worldwide system of tax identification numbers exists, so it is not necessarily true that information provided by a country could be linked to specific taxpayers.

Now we turn to two topics that are important in DTT negotiation although they are not included in the model DTTs. The first topic is tax sparing, reflected in the provisions of Article 23, which requires that foreign tax credit be given only if foreign taxes are actually paid. A number of countries provide for tax-sparing credits; Germany and Japan, for example, give credit for taxes that would have been collected at source from a permanent establishment or a subsidiary except for a tax holiday. The rationale is that a tax holiday in the absence of tax sparing may simply lead to a taxpayer owing more tax to the residence country. However, this maybe be an overly narrow interpretation, because the availability of deferral and averaging (cross-crediting between high and low- tax jurisdictions) mean that tax holidays usually benefit taxpayers even without tax sparing. Tax sparing has been an especially contentious issue in DTT ratification: the

U.S. Senate has been insistent that it will never ratify a DTT that provides for tax sparing, because it can result in double non-taxation.

The second issue involves DTT overrides, which are a mostly American provision with relatively limited scope. The U.S. Congress takes the position that treaties do not have a status above domestic laws; the treaty is superior if it is implemented after a law, but the law is superior

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if it is implemented after the treaty. Treaty overrides are based on the supremacy clause in the U.S. Constitution that says that laws and treaties shall be the supreme law of the land. Because *laws* and *treaties* are used in the same sentence, without a specific priority given to one or the other, the clause has been interpreted to mean that laws and treaties have the same status. However, unlike laws, treaties are negotiated with another party; the other party may feel that it is entitled to the benefits of the treaty without the risk that the treaty will be unilaterally changed by the U.S. Congress, and international law supports this argument. The American position is based on the argument that DTTs are only ratified by the Senate whereas tax laws have to be passed by both houses of Congress, and therefore Congress must to be able to supersede DTTs.

Although DTT overrides are a contentious issue, the actual number of DTT overrides is relatively small. One explicit DTT override was the branch profit tax provision in 1986, which added a limitation-of-benefits rule to preexisting American DTTs that did not have such a provision. This override is generally obsolete now because almost all of the DTTs that it affected have since been renegotiated.

The most recent example of a DTT override occurred in the context of tax arbitrage. This was a situation in which a Canadian company had an American subsidiary with U.S.-source income, which it repatriated to Canada. For U.S. tax purposes, the subsidiary was treated as a branch, and the payments to Canada were treated as interest that was deductible and subject to a reduced withholding tax under the U.S-Canada DTT. For Canadian tax purposes the U.S. subsidiary was treated as a corporation, and the payments were treated as dividends, which are exempt in Canada. The result was double non-taxation.

The United States took the position that a reduction in tax on source income should be contingent on an increase in tax on residence income. The United States therefore passed a DTT override stating that taxation will not be reduced for the hybrid entity that is treated inconsistently. Almost immediately, Canada agreed with the interpretation of the DTT and negotiated a protocol to change the DTT. Although this may imply that the DTT override was unnecessary because the Canadians were willing to renegotiate, it takes a lot of time to negotiate a protocol, so it was not necessarily inappropriate for the United States to use a DTT override.

Because of the contention surrounding DTT overrides, the United States hesitates to make use of the provision and has been very careful not to override DTTs since 1986. In general, the United States attempts to avoid overrides and the appearance of overrides. When the US earning stripping rule (restricting interest deductions to tax-exempt related parties) was enacted in 1989, the United States went to great lengths to avoid the appearance of a DTT override by extending the provision to domestic tax-exempt entities and not just to foreigners, thus preventing an apparent violation of the nondiscrimination article.

In general, DTTs between developing countries and developed countries benefit the developing countries despite the absence of tax sparing because DTTs ensure developed country investors a certain level of institutional stability in the developing country. Empirical economic studies show that the existence of a DTT between two developed countries does not materially affect foreign direct investment, suggesting that DTTs between developed countries mostly affect the distribution of revenue between the governments of the two countries. Similar studies of DTTs between developing and developed countries show that the existence of a DTT has a significant positive effect on the flows of foreign direct investment into the developing country. These studies lend support to the argument that DTTs increase investor confidence in the stability of investing in developing countries, and therefore, although the developing country might forego

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some tax revenue from the DTT, it probably benefits in the long run from the increased foreign direct investment.

Despite the importance of DTTs in the 1963-2013 period, many of the crucial developments in the ITR were due not to DTTs negotiated under the OECD and UN models, but rather die to unilateral actions by the United States that were followed by the OECD and in many cases the rest of the world. These include CFC rules (1962); the classical transfer pricing system (1968) that was later transformed into the OECD guidelines (1977); limitations on treaty benefits (1980); foreign investment in real property (1980); the branch profit tax (1986); anti-hybrid rules (1997); and FATCA (2010). The US also undermined the ITR by adopting unilaterally the portfolio interest exemption (1984) and "check the box" (1997).[208]

3. BEPS 1.0 and the MLI

BEPS 1.0 was the result of the financial crisis of 2008-10, which led to austerity in the EU and the political necessity of imposing tax on multinationals (especially the US digital giants). BEPS 1.0 was a compromise between the EU positions (e.g., action 2, which was aimed at "check the box") and the US positions (deferring action on the digital economy). On the key problematic elements of the treaty network, namely the permanent establishment threshold and the arm's length standard in transfer pricing, not much was done.

An important innovation of BEPS 1.0 was the Multilateral Instrument (MLI), designed as a mechanism to amend many treaties at once to incorporate BEPS 1.0 changes. The OECD published the MLI on November 24, 2016. The OECD stated that –

> The **Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS** will implement minimum standards to counter treaty abuse and to improve dispute resolution mechanisms while providing flexibility to accommodate specific tax treaty policies. It will also allow governments to strengthen their tax treaties with other tax treaty measures developed in the OECD/G20 BEPS Project….
>
> The new instrument will transpose results from the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) into more than 2 000 tax treaties worldwide. A signing ceremony will be held in June 2017 in Paris.[209]

The OECD went on to explain that—

> The multilateral convention was developed over the past year, via negotiations involving more than 100 jurisdictions including OECD member countries, G20 countries and other developed and developing countries, under a mandate delivered by G20 Finance Ministers and Central Bank Governors at their February 2015 meeting…
>
> The OECD will be the depositary of the multilateral instrument and will support governments in the process of its signature, ratification and implementation. A first

[208] See Avi-Yonah, Reuven S., Constructive Unilateralism: US Leadership and International Taxation (June 25, 2015). U of Michigan Public Law Research Paper No. 463, Available at SSRN: https://ssrn.com/abstract=2622868 or http://dx.doi.org/10.2139/ssrn.2622868.

[209] OECD, Countries adopt multilateral convention to close tax treaty loopholes and improve functioning of international tax system (Nov. 24, 2016).

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> highlevel signing ceremony will take place in the week beginning 5 June 2017, with the expected participation of a significant group of countries during the annual OECD Ministerial Council meeting, which brings together ministers from OECD and partner countries outside the OECD.

The new OECD MLI is not a full-fledged multilateral tax convention covering all the areas that are usually covered by bilateral tax treaties. Instead, it can be thought of as a global consensual treaty override designed to apply the results of BEPS simultaneously to all the tax treaties where the countries involved agree.[210] The MLI is implemented by countries signing and ratifying it according to their usual constitutional norms and then depositing the ratification with the OECD. Upon ratification, the provisions of the MLI apply to override the relevant provisions of all the bilateral treaties of a depositing country, unless there is a reservation (which is not allowed in some cases involving minimum BEPS standards).

In addition, the new OECD MLI includes a wide-ranging dispute resolution mechanism including mandatory arbitration. Mandatory arbitration has recently been introduced into the OECD and US models, but it is still lacking in the UN model and most actual treaties. The effect of including it in the MLI can be to force binding arbitration on all existing treaties, which proved controversial, especially in the US (a late and reluctant convert to the cause of arbitration in tax treaties) and among developing countries.

Despite these steps forward, the MLI is not a MTC, and the question of whether to conclude a MTC was left for future discussions.

4. BEPS 2.0 and the MTC

BEPS 2.0 (2018-) was the result of countries responding to the problem of how to tax the US digital giants (Amazon, Apple, Facebook, Google, Netflix) in the absence of a PE. Beginning with the UK in 2015, over 30 countries (as well as the EU) have adopted or proposed gross-based digital services taxes. These DSTs were considered discriminatory by the US, leading to the threats of trade sanctions. In addition, since they were not income taxes and therefore not subject to tax treaties, the OECD regarded them as a threat to its dominance of the ITR via the model.

In BEPS 2.0, the OECD in Pillar 1 finally abandoned both the PE limit and the ALS for part of the revenue derived from a market by large MNEs (over 20 billion Euros in revenue), but only if the MNE derives over $1 million Euro in profit from the market. This “Amount A” constitutes 25% of the profit that exceeds 10%.

Because Amount A requires modifying articles 5, 7 and 9 of all the DTTs, it requires a MTC to come into effect. This, if Pillar 1 succeeds, the world will finally have a MTC. In the last section we will examine the prospects for such a MTC.

5. Conclusion: Can a MTC Succeed?

Unfortunately, the prospects of Pillar One succeeding are not good, for three reasons. First, because Pillar One must eliminate both the PE threshold and the ALS for Amount A, it

[210] See generally Avi-Yonah, Reuven S. and Xu, Haiyan, A Global Treaty Override? The New OECD Multilateral Tax Instrument and Its Limits (March 17, 2017). U of Michigan Public Law Research Paper No. 542, Available at SSRN: https://ssrn.com/abstract=2934858 or http://dx.doi.org/10.2139/ssrn.2934858.

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requires an MTC, and that is hard, as many failed efforts from the days of the League of Nations attest.[211]

Second, even if an MTC is ratified by enough countries to come into effect, it is highly unlikely to be ratified by the US Senate, and US participation is essential because most of Amount A will be paid by US-based Big Tech MNEs.

Third, Pillar One requires the abolition of all DSTs, but over 30 countries have DSTs, and they are politically popular, so that it will be hard to abandon them.

The UN has proposed instead to impose withholding taxes on payments for digital services, but these are inherently limited because like DSTs they are gross-based, would not be includible in US treaties, and would not apply to users of e.g. Facebook or Google because they do not pay (and advertisers can be located in third countries not subject to the treaty).[212]

A more promising approach is unilateral adoption of Pillar One (or at least Amount A). After all, Pillar One was already accepted in principle by 141 countries, so that unilateral adoption would not be violating international norms. This way ahead was shown by the Indian proposal (before Pillar One was agreed to) to tax MNEs operating in India on a portion of their profits derived from sales into India without regard to the PE and ALS limitations.[213]

What has been proposed is a “fractional apportionment” method, based on profits derived from India. It differs from FA since it limits itself to India related information; it does not require consolidating profits from all tax jurisdictions. The proposed method relies primarily on information relating to Indian operations and adopts a 3-factor formula (based on the CCCTB), according equal weight to sales, employees (manpower and wages), and tangible assets. In addition, the proposal suggests a formula for calculating the profits derived from India, which relies on the non-resident’s revenue derived from India and its global operational profit margin. The proposal also offers a solution to tax the digital economy; it allows user participation to count as the 4th factor in the fractional apportionment method; the relative weight of the user participation may range from 10% to 20%, depending on the user intensity of the business enterprise concerned. The proposal does not rely on either the PE limit or the ALS.

For countries like the US, the UK, Australia, and even Germany that can override treaties unilaterally, the Indian proposal offers a way to implement Pillar One without requiring a MTC.[214] Such unilateral actions to allocate profits to destination jurisdictions is an appropriate response to digitalization and tax competition. It preserves both openness to FDI and the ability of sovereign countries to impose taxes on MNEs deriving billions of profits from their markets and benefiting from the education, infrastructure, and rule of law that the destination country provides. For countries that cannot override treaties, it must be hoped that such unilateral adoption would induce them to ratify the forthcoming OECD MTC even without US participation, and that the US would grant foreign tax credits for the taxes imposed by these countries. After all, as the four economists wrote a century ago, it is hard to deny the justice behind a destination country’s claim to some of the tax revenue resulting from selling goods or services to its residents.

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[211] See Part I above.

[212] UN Model Tax Convention, Article 12B (2021).

[213] See Reuven Avi-Yonah and Ajitesh Kir, *India’s New Profit Attribution Proposal And the Arm’s-Length Standard, 93 Tax Notes Int’l 1183 (June 17, 2019).*

[214] On treaty overrides see, e.g., Avi-Yonah, Reuven S., Sunt Pacta Servanda? The Problem of Tax Treaty Overrides (May 2, 2022). U of Michigan Public Law Research Paper No. 22-022, Available at SSRN: https://ssrn.com/abstract=4098235 or http://dx.doi.org/10.2139/ssrn.4098235.

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This issue is related to a broader question: Are the bilateral tax treaties still needed in the 21st century? After all, the VAT seems to operate reasonably well (albeit not perfectly) in the absence of tax treaties. What makes the income tax different?

There are three traditional rationales for income tax treaties. First, tax treaties eliminate double taxation by requiring each of the two contracting states to provide either an exemption for foreign source income or a foreign tax credit for taxes imposed by the other states (subject to the limitations on source taxation imposed by the treaty). Second, the treaties implement the compromise between residence and source jurisdictions by shifting the tax on passive (investment) income to the residence jurisdiction while maintaining source-based taxation of active (business) income, subject to the PE and ALS limits. Third, the treaties combat tax evasion by providing exchange of information.

None of these reasons seems particularly persuasive in the 21st century context. First, as Tsilly Dagan pointed out in 1999, double taxation is usually avoided without treaties by countries unilaterally granting either exemption or foreign tax credits.[215] There are only a few instances where a treaty is needed to prevent double (residence/source) taxation, and treaties are ineffective in preventing source/source double taxation resulting from disagreements about transfer pricing or the characterization of income.

Second, taxation on passive income in a world characterized by tax competition for portfolio investments is generally avoided by countries granting unilateral exemptions from withholding. For example, capital gains are not subject to withholding even if they represent stock buybacks by the issuing corporation (and are therefore a direct substitute for dividends). Interest payments are generally not subject to withholding since the US unilaterally exempted them in 1984. Royalties are rarely paid between unrelated parties, and royalties between related parties should be taxed at source (contrary to treaties based on the OECD/US models) because of the potential to shift profits and lack of comparables. Finally, dividend withholding can be avoided either through buybacks or by using derivatives that are economically equivalent to holding the underlying stock.

Third, tax evasion is already adequately addressed by the Common Reporting Standard (CRS) and the Multilateral Agreement on Administrative Assistance in Tax Matters (MAATM), as well as unilateral enforcement by the countries involved (e.g., the US FATCA), so that the treaties are not needed for this purpose either.

The treaties do enforce the PE and ALS limits on the taxation of active income, but as discussed above these limits are obsolete and should be replaced by the unilateral adoption of FA.

[215] Tsilly Dagan, The Tax Treaties Myth, NYU J Int'l L. & Pol. (1999).

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If Pillar One collapses because the US refuses to adopt it and countries do not give up on DSTs that may lead to the collapse of the whole treaty network (the point of DSTs is that they are not subject to the PE limit because they are not income taxes). The OECD would lose control over international taxation, but that may not be a disaster either given how unrepresentative it is.

The tax treaties impose significant limits on the ability of countries to impose taxes on cross- border income. They also enshrine what may be obsolete classification of income into dividends, interest, royalties and capital gains. It is quite plausible that after a century the usefulness of bilateral tax treaties has run its course, and that income taxes can manage well without them, like the VAT already does. That is particularly true because the distinction between income taxes and VATs becomes increasingly blurry as income taxes shift toward a hybrid income/consumption tax model by allowing expensing of capital expenditures, and as it is increasingly unclear who bears the economic burden of either income taxes or VAT.

But this pessimistic outlook does not mean that multilateralism has no role to play in income taxation. They key questions for determining whether multilateral solutions are feasible are (a) the number of countries that need to agree, (b) the extent to which country interests diverge.

The problem with negotiating an MTC for Pillar one is that first, since most countries are destination countries (markets) for digital services, many countries must agree (e.g., the over thirty countries that already have or are about to implement a DST, and that must agree to give it up). In addition, the interest of countries that are only the market for digital services diverge from that of countries where providers of such services reside (primarily the US, but also some EU countries). Some countries (e.g., Nigeria) have already refused to agree to Pillar One because of the revenue loss it involves. Under these circumstances, it is hard to see how a Pillar One MTC can succeed.

Pillar Two, on the other hand, is much more likely to succeed because (a) it does not require an MTC because it relies on existing tax instruments like the US GILTI and BEAT; (b) it only requires coordination among the countries in which large MNEs are resident, i.e., the G20 (over 90% of the large MNEs reside in them), and (c) the interests of such large economies in taxing their MNEs in coordination with other countries to prevent tax base erosion through tax competition are similar.

Another example of successful multilateral income tax coordination is the Multilateral Agreement on Administrative Assistance in Tax Matters (MAATM), which implements automatic exchange of information based on the Common Reporting Standards (CRS) to prevent tax evasion. Most countries of the world other than the US have ratified the MAATM, and the US is effectively implementing it via the network of over 100 intergovernmental agreements (IGAs) that it negotiated to implement FATCA. The reason for this success is (a) the unilateral action by the US in applying FATCA extraterritorially, which forced foreign banks to comply and to pressure their governments to adopt the IGAs and CRS, and (b) the shared interest of most countries in preventing the kind of tax evasion by the rich documented in the Panama, Paradise, and Pandora Paper leaks. Under these circumstances a limited MTC was negotiated successfully despite the large number of countries involved.

The MAATM may be the best example for countries to follow if they wish to negotiate a MTC. The success of this endeavor, given the large number of countries involved, will depend on the degree to which they share a common interest beyond unilaterally adopting the destination principle. Like the UN model, such a MTC can leave the precise withholding tax

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rates (as well as the method for relieving double taxation) to bilateral negotiations and focus instead on implementing the political compromise embodies in Pillar 1. Together with the global minimum tax (Pillar 2) which does not require a MTC, this can be an appropriate basis for ITR 2.0, and finally bring the ITR into the multilateral era that has dominated international law in the post-World War 2 era).

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