The Old Guard of International Taxation

Adam Becker
Paul Becker
Will Mawer

I. Introduction

Had one decided to pen a history of international tax law, they should soon realize what a grave mistake they have made. That is not to denigrate the profession – and anyway, no one could say it better than "international tax law is horrible and only nerds understand it."[1] Instead, what our ill-advised historian would find is just how uneventful the development of international tax law has been. From arguably its founding moment, that being the conclusion of the first tax treaties in the early 1870s,[2] until present day, the prevailing order of international tax law has been largely the same: developed, industrialized nations agreeing on certain principles by which their domestic companies could pursue foreign opportunities unimpeded by the prospect of double taxation.

Although this order has persisted until present day, two significant developments have shifted and shaken the ground beneath it: first, the world has become a true global economy implicating and involving virtually every country on earth; and second, the industrial age context in which principles of international tax law were first conceived and developed has been subsumed under the digital age. Profits built on bricks and mortar have given way to those attributable to patents and copyrights. The need to know the lay of the land has fallen to the power of branding and a globally shared experience. This is not to long for more provincial and luddite times; instead the purpose here is to introduce the consequences of law – in this case, international tax law – falling behind the times.

With this paper, we hope to expand further on this central theme that several of the core principles and understandings of international tax law are in need of reconsideration, if not outright overhaul. In the space provided, we will introduce these core principles, identify the major challenge to their primacy, and offer a few real world examples of how outmoded principles can leave a starkly global and digital economy caught in the trappings of the past.

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1 Peter J. Wattel, 'Red Herrings in Direct Tax Cases before the ECJ', *2 Legal Issues of Economic Integration 31* (2004), pp. 81–95.

2 Alexander Rust, '"Business" and Business Profits"', in: Guglielmo Maisto, ed. *The Meaning of "enterprise", "business" and "business Profits" Under Tax Treaties and EU Tax Law*, (Amsterdam, IBFD, 2011), at p. 100.

II. Background

The centrepiece of this discussion is the tax treaty, often called a "DTA" (i.e., double tax agreement) for short. Of the 3000-plus DTAs[3] in existence today, the vast majority are based on the same framework, which was first formalized with the nascent League of Nations' efforts, particularly its 1923 Report on Double Taxation,[4] to harmonize the existing network of bilateral tax conventions that Central European countries in particular had developed prior to the First World War.[5] The League of Nations was not long for this world, as our ill-advised historian would surely know, but sometime later, after the world and particularly Europe emerged from the Second World War, the Organisation for Economic Cooperation and Development (OECD) picked up where the League of Nations left off and ultimately published its "Model Convention with respect to Taxes on Income and Capital" in 1963.[6] The United Nations later began to consider tax issues and in 1980 published its own Model Convention, although it too was substantially based on the League of Nations' 1923 Report and, in turn, the OECD MC.[7]

The countries that devised and refined the first DTAs tended to rely on two foundational principles for jurisdiction to tax: source and residence, which are forms of objective jurisdiction (i.e., jurisdiction over an object) and personal jurisdiction (i.e., jurisdiction over a person), respectively.[8,9] Of course, with competing forms of jurisdiction comes the potential for overlaps, or so-called juridical double taxation, meaning two countries seeking to tax the same person on the same item of income. These overlaps of jurisdiction come in three forms: first, residence-residence conflicts, where two countries each claim a company as resident and each seek to tax on a personal basis;[10] second, residence-source conflicts, where one country makes a tax claim based on residence while another asserts a claim based on source; and third, source-source conflicts, where two countries seek to tax the

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3 Jeffrey Owens and Mary Bennett, 'OECD Model Tax Convention: Why it works', *OECD Observer No. 269* (2008).

4 Gijsbert W.J. Bruins, Luigi Einaudi, Edwin R.A. Seligman, and Sir Josiah Stamp, Report on Double Taxation, League of Nations Doc. E.F.S.73.F.19 (1923), at pp. 5-17 ('1923 LoN Report').

5 Klaus Vogel, 'Double Tax Treaties and Their Interpretation', *4 Berkeley Journal of International Law 1* (1986), pp. 1-85, at p. 10-11.

6 *Ibid.*

7 For the purposes of this paper, 'MC' will refer exclusively to the OECD and UN Models. Furthermore, when used in the singular 'MC' should be read as applying to any of the two models without need for distinction.

8 Also called 'in rem' jurisdiction and 'in personam' jurisdiction, respectively.

9 Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (Alphen aan den Rijn: Kluwer Law International, 2010), at pp. 431 and 495.

10 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer* (The Hague: Kluwer Law International, 2002), at p. 27.

same item of income of a company each on a source basis.

Historically, source taxation was founded on an exchange theory of public finance, where taxes paid to a state were viewed as *quid pro quo* for benefits derived from the state and its territory.[11] Not surprisingly, this approach became known as the "benefit principle". In viewing source taxation as an exchange, scholars and policymakers tended to regard all taxpayers as equal: the price of a public good should not cost more on a per-use basis for one person than the next. Even more, because source taxation treated all taxpayers as essentially counterparts in a *quid pro quo* exchange, there was little impetus to consider another tax claim. If the taxpayer had benefitted from the country's infrastructure, they should be liable to pay for that benefit. Thus, in concrete terms the benefit principle justified proportional tax rates levied on all taxpayers regardless of their personal circumstances, such as their actual desire for public goods or their relative ability to pay.

The residence principle arose in response to each of these issues. Through residence taxation countries could circumvent this problem of subjective public wants and tax on an "ability-to-pay principle" basis.[12] The ability-to-pay principle construed paying taxes not as an exchange but as a legal obligation pursuant to the state's role to protect and plan for the public welfare.[13] According to this principle, since wealthy taxpayers have greater economic interests to protect than their counterparts, and in achieving wealth have derived comparatively greater benefits from the overall social structure, then reason would dictate that wealthy taxpayers should contribute proportionally more of their wealth to fund the state *qua* the planner and protector of social interests.[14] In economic terms, the ability-to-pay principle gained further support from the idea of diminishing marginal income utility, which held that each additional dollar of income that a taxpayer accrues contributes less to the growth of the economy because the taxpayer shifts its preference from consumption to savings[15] (an argument that supported both progressive tax rate structures and personal deductions for taxpayers). As a result, for developed, mostly Western countries, income taxation ultimately acquired a more personal scope that took consideration of the taxpayer itself, and not just each item of income it derives.

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[11] Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (McGraw-Hill, 1959), at pp. 61-89.
[12] See Musgrave, *supra* note 11, at p. 90-115.
[13] *Ibid*.
[14] *Ibid*.
[15] *Ibid*.

This personal scope came with one major caveat: to give full consideration to a taxpayer's circumstances, including its ability to pay, a country had to take account of *all* its income, no matter the source. This is because different taxpayers may have different gains and losses outside the country, and thus they would have different abilities to pay domestic taxes. The League of Nations' 1923 Report on Double Taxation articulated this principle as such: "[T]axes, though measured by things, eventually fall upon persons and ought to fall upon them in the aggregate according to the total resources of the individual, leading to progressively larger sums being paid."[16] Accordingly, a country that asserts jurisdiction over a taxpayer on a personal, or residence, basis must necessarily assert jurisdiction over the worldwide income of its resident taxpayers. As such, the incidence of double taxation was unavoidable.

III. Tax treaties and double taxation

DTAs generally seek to resolve only the first two conflicts mentioned above: residence-residence conflicts and residence-source conflicts.[17] In resolving residence-residence conflicts, DTAs generally side for the country that asserts jurisdiction based on the company's place of effective management, as opposed to other criteria like place of incorporation or registration. This is generally uncontroversial, as a company can have only one place of effective management, and countries tend to agree that a true "domestic" company is one that has its headquarters there, as opposed to one whose connection is a corporate charter (compare, e.g., whether Apple is for all intends and purposes a California-based company or a Delaware-based company). As for source-source conflicts, we find that most DTAs avoid outlining extensive source rules, thereby failing to comprehensively distinguish between country claims as being the true or dominant source of the income.[18]

That leaves us with residence-source conflicts, which is where DTAs have had their greatest impact on cross-border taxation and inter-nations equity. Owing to their creation by developed countries with large domestic enterprises, DTAs both historically and still today operate most significantly to limit the impact of source state taxation. This is accomplished first through reduced withholding rates on passive income (some articles, e.g., Article 12 of the OECD MC, restrict source taxation altogether), which effectively reduces only quantum, not the scope, of source state taxation. More significantly, however, DTAs also include a

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[16] See 1923 LoN Report, *supra* note 4, at p. 20.
[17] See Arnold and McIntyre, *supra* note 10, at p. 28.
[18] See Arnold and McIntyre, *supra* note 10, at p. 28.

qualitative restriction called the permanent establishment, or PE, which generally limits source state taxation unless the company has some sustained value-adding physical presence operating in the source country's territory. The most common definitions for such presence are a fixed place of business, a dependent agent acting on the company's behalf, or a building, construction, or installation project, provided (particularly in the first case) that the activity does not involve such activities as storage, display, delivery, or other activities assumed to be preparatory or auxiliary and too remote to the creation of profits.

If we recall the basis of source taxation as a *quid pro quo*, these sorts of restrictions should come as some surprise. After all, if based on the benefit principle a purely domestic company would be taxed on income connected with such activities, or would be taxed at a certain rate without reduction, why should a foreign company not be taxed as such? The benefit is the same regardless of who derives it.

IV. New entrants to the global tax order and the rise of the digital economy

Of course, this was true 100 years ago just as it is now, but the impact is far more severe when one of the parties to the DTA relies almost exclusively on source taxation for public revenue. Such tends to be the case with developing countries, who may be rich in resources and have burgeoning purchasing power but lack the sort of large domestic companies that would generate significant residence-based tax revenue. As described at the outset, the prevailing order of international taxation was developed by and for developed, industrialized countries, which is why the DTAs are so favourable to residence taxation. As other countries began to enter the global economy, however, they were effectively forced to sign on to the same order, much to their detriment. For this reason, scholars who advocate for greater emphasis on source taxation have therefore decried the MCs as distorting the balance of tax revenue when signed between source-based and residential countries.[19] Some have gone so far as to call the residence-based global tax order a form of "fiscal imperialism," on the grounds that source taxation is the most just means of allocating tax jurisdiction in the case of jurisdictional conflicts.[20]

This problem is further compounded by the advent of the digital economy, which is the

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[19] Sergio André Rocha, 'International Fiscal Imperialism and the "Principle" of the Permanent Establishment', *68 Bulletin for International Tax 2* (2014), pp. 1-6, at p. 1.

[20] Lee A. Sheppard, 'OECD Officials Make Annual Visit to IFA World Congress', *Tax Analysts* Doc 2005-19508 (Falls Church, USA: 2005), at p. 1.

second issue we highlighted above. Traditionally, deriving value and/or income from a source country required a certain degree of presence within that country's territory, which would ultimately support a source state tax claim. If a company wanted to sell its new widgets in a far-off land, it would need local warehouses and sales agents at a minimum. Such activities would certainly make use of local infrastructure, and indeed the company would benefit from the improvement of that infrastructure by minimizing its risk of loss and achieving greater efficiency in its operations. The case for source state taxation on the basis of the benefit principle could scarcely be more clear.

Unbeknownst to few, over the past several decades the global economy has evolved and innovated, digitized and integrated. The internet and global telecommunications networks can bring a company to a customer's digital doorstep in a millisecond, no billboards or door-to-door salesmen needed. Even more, companies are increasingly selling digital products like apps and digital services like cloud computing, which altogether vitiates the need for warehouses and physical distribution.

V. Case studies

Two scenarios will help illustrate the negative impact the old global tax order has had on inter-nations equity in light of the two changes – the integration of emerging economies and the advent of the digital economy – introduced above. The first scenario involves an online retailer, non-resident company carrying on substantial distribution activities within the territory of a country seeking to tax.[21] In this industry, distribution represents a major value adding activity because customers value the ability to browse products online and receive their order the next day, which makes this particular company's unrivaled distribution network its primary competitive advantage.

In this scenario, the company undoubtedly has a presence, and furthermore an income-producing presence, within the territory of the country seeking to tax. Accordingly, the benefit principle should theoretically support a domestic law claim to tax the company on its activities within the country's borders. Although distribution might not be the only activity contributing to the production of income (e.g., also playing a substantial role is the

[21] The reader should understand the hypothetical company as operating a business model similar to that of Amazon. See e.g., Tom Bergin, 'OECD unveils proposals to curb corporate tax avoidance', *Reuters.com* (London: Reuters, 2014), http://www.reuters.com/article/2014/09/16/uk-oecd-tax-idUKKBN0HB19F20140916 (last accessed 25 July 2015).

management of the distribution network from the head office, which will generally be in the company's residence state), the fact remains that there is a strong economic attachment of the income to the country's territory that should support a source state tax claim. If the country's residence state wishes to tax then, it should do so on the residual amount, if at all, leaving the source state claim untouched.

The MC, and therefore most DTAs, presently includes a sufficient mechanism for resolving this issue, and one that keeps in line with the principles underpinning source taxation. Article 7.2 of the MC requires the determination of the taxable income based on the arm's length principle.[22] Thus, in the above example the source state would limit its tax claim only to income considered to have arisen due to the distribution activity, and not any other activity. The authors submit that this is the appropriate, even the ideal, means by which to settle the issue of tax sharing between the source (origin) state and the residence state.

However, the MC makes a critical misstep by imposing a source threshold, in this case in the form of the PE, instead of simply resting on the arm's length principle.[23] Under the OECD MC, for instance, distribution activities are excluded from creating a PE under Article 5.4 (under the UN MC, no distribution exclusion exists).[24] Recently, this has created much controversy, particularly in the context of retailers like Amazon (upon which this example is based), because countries that have signed OECD-type DTAs are prohibited from taxing income they feel has been produced within their territory. In cases such as Amazon, these countries are nonetheless justified in arguing that the income has been produced in their country and thus should be taxable according the source principle. It is only the old-order DTAs, which were designed to apportion tax jurisdiction in the context of bricks-and-mortar businesses, that prevents the source country from asserting a tax claim.

Let us consider a second scenario before further analysis. In this case, a global internet company derives substantial amounts of income through the sale of online advertising space on its website.[25] The company's website is popular and of course globally accessible, and to increase its advertising revenues the company collects information for the purposes of

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[22] Art. 7.2 OECD Model (2010); Art. 7.2 UN Model (2011).
[23] Art. 5 OECD Model (2010); Art. 5 UN Model (2011).
[24] Art. 5.4 OECD Model (2010); Art. 5.4 UN Model (2011).
[25] The reader can understand the hypothetical company as operating a business model similar to that of Google. See e.g., See e.g., Tom Bergin, 'OECD unveils proposals to curb corporate tax avoidance', *Reuters.com* (London: Reuters, 2014), http://www.reuters.com/article/2014/09/16/uk-oecd-tax-idUKKBN0HB19F20140916 (last accessed 25 May 2016).

targeted (specifically, location- and language-targeted) advertising. Accordingly, local businesses in a source country where the company has no physical presence frequently purchase advertising space on the company's website hoping to target primarily local customers. That is, fixed between a local business and its intended local audience – consider a furniture store in Korea and its exclusively Korean customers – is a large American company deriving advertising revenue. The global digital economy permeates even the most local of economies.

In this scenario, nearly every DTA, and naturally both the OECD and UN MCs, prohibits the source country from taxing on a source basis for lack of a PE located within its territory. Those DTAs were formulated to consider only physical, human presence as sufficient to give rise to a tax claim. No amount of digital presence, for instance, could be sufficient for a valid tax claim to arise. As in the case before, however, an argument could be made that the company has made use of rights, property, or capital[26] in the territory of the country so as to produce income. The company is certainly availing of local telecommunications networks to access its intended customers, and furthermore the company has aggregated customer data to make its advertising highly targeted based on demographics and customer preferences. In this sense, the income derived by the company shares a unique economic attachment with the source country, which could arguably support a claim for source taxation.

In each case, we witness the inescapable consequence of negotiating away source jurisdiction. So long as a country's domestic source jurisdiction comports with the notion of territoriality (that is, its jurisdiction does not extend beyond its borders), it seems clear that such country should not forgo its jurisdiction so indiscriminately by signing an antiquated DTA. It is true, of course, that in exchange for this exclusion the country presumably secured the same exclusion from its DTA partner. Thus, so long as the parties were on equal footing, the negotiated result should generally be seen as fair irrespective of changed circumstances or the failure of reciprocal advantages to materialize. However, where one country derives the majority of its revenue from source taxation while its prospective DTA partner benefits more from residence taxation, the two countries are fundamentally on different footing when it comes to each treaty provision.[27] A source threshold or sourcing rule will affect the two countries very differently.

This is not to say that source jurisdiction should never be negotiated away through the use of

[26] Most notably, the company makes use of local telecommunications infrastructure.
[27] See Rocha, *supra* note 19, at p. 4.

DTAs. Instead, the point here is, first, a fundamental one that countries negotiating treaties should be aware of the consequences of such decisions and should demand equal concessions to taxing rights in exchange for forgoing source jurisdiction. More importantly, however, a country that relies heavily on source taxation should use DTAs primarily for the purpose of harmonizing the source rules of both countries so as to avoid source-source conflicts, and only agree to restrict source jurisdiction more narrowly where there is a mutual interest in the promotion of cross-border business (e.g., both countries might offer an exemption from tax on certain activities in the interest of promoting an industry or increasing foreign direct investment from the treaty partner). Even then, the source country might consider the use of a quantitative threshold – forgoing taxation on income derived from the local activities of the DTA partner's resident companies up to a certain income threshold – instead of a qualitative threshold, which has proven significantly more inconvenient in light of the burgeoning digital economy.[28] This would help to minimize any obstacle that taxation poses on cross-border business without negotiating away source jurisdiction, especially in the absence of a mutual concession from the DTA partner.

VI. Going forward

It would seem that some sort of compromise or re-consideration would be in order. From a purely monetary and political perspective, the current global tax regime's preference for residence country taxation will serve to further increase the wealth divide between developed and developing countries, as the latter continue to rely heavily on source taxation. The obvious solution would be to make the necessary changes in existing DTAs, particularly to the permanent establishment concept, to include language more conducive, or perhaps less hostile, to source country taxation.

This option is not without difficulties, however. First, the primary forum for discussion and re-consideration of the global tax order is the OECD, or the so-called "rich country club"[29] of mostly Europe, the U.S. and their primary allies, meaning that advocating a phase shift away from residence taxation would be a massive, if not foolhardy, endeavor (indeed, of the 34 member countries, only perhaps Chile has a strong source state inclination, as is popular in Latin America[30]). Second, and more significantly, amending and re-formulating the language

[28] Arthur J. Cockfield, 'Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test', 38 Canadian Business Law Journal (2003), pp. 400-422, at p. 400.
[29] The Economist, 'The OECD and corruption: The tents of the righteous' (Sep 17th 2011).
[30] See, e.g., Sheppard, *supra* note 20.

of some 3000 DTAs would require a sustained, decades-long effort, even assuming there was uniform support and agreement. Of course, such agreement is currently lacking, particularly where it concerns the development of new principles to contend with the new digital economy. Indeed, the OECD's recent attempt, as part of its Base Erosion Profit Shifting (BEPS) report,[31] to identify and define a " significant digital presence" has largely been met with disregard.

The issues discussed herein are not necessarily unknown or unheeded within the international tax community. In fact, their impact is even being felt by a few traditionally rich countries, whose economies have not digitized at the same pace as, e.g., the U.S., Scandinavia or East Asia. Furthermore, in Europe and particularly the U.K. the general public has acquired a more acute perception of tax avoidance, particularly by large U.S. companies like Google, Amazon and Starbucks, which has brought a powerful public relations slant to the issue of equitable tax distribution.[32] Support for a comprehensive rethinking and retooling of the global tax order could thus conceivably be on the horizon, but even then it would seem overly optimistic to expect significant and uniform action to be taken any time in the foreseeable future.

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[31] Organisation for Economic Cooperation and Development, *BEPS Action 1: Address the Challenges of the Digital Economy*, (Paris: OECD, 2014).

[32] See, e.g., Sol Picciotto, 'UK's proposed "Google Tax": jumping the gun?', Tax Justice Network Online (Chesham, UK: 2014) http://www.taxjustice.net/tag/permanent-establishment/ (last accessed on 25 May 2016).