

The Forgotten Addendum

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The four economists' report that laid the foundations for the international tax regime over a century ago focused on individual taxation.¹ This is clear from the following statement, which reflects the views of the Report's principal author, Prof. E.R.A. Seligman:

The ideal solution is that the individual's whole faculty should be taxed, but that it should be taxed only once, and that the liability should be divided among the tax districts according to his relative interests in each. The individual has certain economic interests in the place of his permanent residence or domicile, as well as in the place or places where his property is situated or from which his income is derived.²

This is based on the principle of ability to pay, which Seligman advocated and which became the underlying principle of the Sixteenth Amendment, which allowed Congress to tax individuals on all their income 'from whatever source derived'.

Because of the preference for ability to pay taxation, the Report advocates taxation on a residence basis with a foreign tax credit for source-based taxes to prevent double taxation, or the abolition of source taxation. It also accepts division of the revenue by formula, but emphasizes that this method should not result in a lower tax than pure residence taxation:

Now it is of the essence of this method that the resident shall not gain by the relief in double taxation, that is, shall not be in a better position than he would be if his income were all derived in the country where he resides. Relief is desired only to the extent of the excess over such a sum; and therefore the essence of method 3 is that the country of residence should give relief by a definite amount that has been

levied in the country of origin, with, if it is desired, a maximum for that relief equal to one-half of the rate of tax levied by the country of residence.³

Finally, the report accepts classification and assignment, which was the method ultimately adopted by the League, but it again emphasizes that there should be no exemption, so that if the source country does not tax the income assigned to it (active income), the residence country should tax it:

By convention it might be determined to attach origin taxation specifically and wholly to particular classes of investments or embodiments of wealth, such as rents of land and of houses and mortgages on real property, but to exempt the non-resident in respect of income derived from business securities. The country of residence would allow the whole of the foreign tax as a deduction from its income tax on the resident in respect of such sources of income, but would charge other sources in full. The country of origin would retain its specific origin taxes in full. It would be necessary to give the country of residence complete power of charging all sources except for certain specified exemptions, so that the scope of its liability to remit the tax would be easily determined, and the investor, from his total income-tax demands, would be able to deduct certain specified taxes on any real property he might have. It might be desirable to impose some limit upon the power of the country of origin to levy in future specially heavy specific origin taxes, which would unduly deplete the exchequer of the country of residence. This may be called *the method of classification and assignment of sources*.⁴

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** I would like to thank Sol Picciotto for pointing out the addendum and for helpful comments.

¹ League of Nations, Economic and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, E.F.S. 73. F.19 (League of Nations 1923) (the Report).

² Report, 20.

³ Report, 46 (emphasis added).

⁴ Report, 43 (emphasis added).

All of this is consistent with the single tax principle, under which cross-border income should not be either overtaxed or undertaxed compared to domestic income. The same principle underlies Pillar 2.⁵

These parts of the Report are well known, albeit controversial.⁶ But the Report also contains an Addendum by Seligman which is less well known, and which discusses a topic that later became key to the work of the League of Nations and to the international tax regime: How to allocate income among source jurisdictions.⁷ This was particularly important for corporate taxpayers subject to high taxes in Europe, and especially to US corporations, since from 1921 on the foreign tax credit was limited to the US tax rate times foreign source income. The Report was commissioned by the League based on an appeal from the International Chamber of Commerce, which represented corporate taxpayers.

The Addendum is as follows:

Allocation of earnings where the whole of the economic stages are not conducted within one area

Reference has been made in the course of the report to different degrees of allegiance which may attach to different stages of what is in the last resort a single economic action, but which can be subdivided and is in actual practice often subdivided. For example, there is first the mere sale of produce in a country where all stages up to the production of the finished article may be carried through elsewhere. Secondly, the products may not be merely sold but also adapted or altered in some way after arrival in the country. Thirdly, the actual manufacture or production may take place in the country, but the extraction of raw material and so on may be effected entirely abroad. Fourthly, in modern highly integrated industries, all stages of production, from the extraction of raw material or the growth of produce to the manufactures resulting therefrom and the final sale may take place in the hands of a single corporation, and the final result of all these stages, which may in other countries be in the hands of separate industries or people, will be represented in a single profit-and-loss account. The problem that arises in practice is how the result can be subdivided in order to indicate the different degrees of claim that a State may have upon each operation. The case of a company

performing several of these operations in country A but the final operation of sale in country B is held to give country B a special claim upon the tax on the profit, but not upon the whole of it; and criteria have to be sought for assigning the profit to the other respective areas in which the economic stages have been conducted.

Such criteria of division are perhaps more easy to arrive at where a company carries on identical operations in two separate States. The more difficult cases arise where what is done in two separate States is not identical. The criteria of division of the results that are generally adopted in practice include the following:

1. Value of sales.
2. Total capital involved in the business in each country.
3. Total stocks of goods maintained in each country.
4. Mere property or real estate is involved, the total value in each country (this may be modified, where value is not appropriate, by total area, cubic space or other criteria for productive output).
5. Total salaries and establishment expenses.
6. Total credits arising in each country.

The suitability of criteria depends entirely on the nature of the business, and generally their application is ad hoc. Illustrations exist, for example, in different American States of methods of dividing the property or profits of franchise companies like railways as well as of general business corporations. This is especially true of the recent income taxes in New York, Massachusetts and Wisconsin. It may well be that the experience of more advanced countries in these matters could profitably be collected and collated and used as the basis of conventions for countries to whom they are more or less novel. It would be outside the scope of our enquiry to point to any theoretical conclusions as to which are the appropriate criteria for different classes of business, since so much depends upon what is practically available in the way of accountancy details and upon the actual economic structure of the business under consideration. It is only necessary here to say that when the criteria have been adopted and division of resources or profits has been accordingly made, then the different degrees of economic obligation on the part of the profit-making business to the respective countries is theoretically capable of discussion.

Notes

⁵ On the STP see Avi-Yonah, *International Taxation of Electronic Commerce*, 52 Tax L. Rev. 507 (1997), doi: 10.2139/ssrn.3920270; Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 NYLS L Rev 305 (2015), doi: 10.4337/9781781952320.00018; Avi-Yonah, *Full Circle: The Single Tax Principle, BEPS, and the New US Model*, 1 Global Tax'n 12 (2016), doi: 10.2139/ssrn.2673463; Avi-Yonah & Gianluca Mazzoni, *Stanley Surrey, the 1981 US Model, and the Single Tax Principle*, 49 Intertax 729 (2021), doi: 10.2139/ssrn.3816314; Avi-Yonah, *The 1923 Report and the International Tax Revolution*, 51 Intertax 427 (2023), doi: 10.54648/TAXI2023039.

⁶ For a critique dismissing the importance of the Report see Michael J. Graetz & Michael M. O'Hear, *The Original Intent of US International Taxation*, 46 Duke L.J. 1021 (1996), doi: 10.2307/1372916; but see Avi-Yonah, *All of a Piece Throughout: The Four Ages of US International Taxation*, 25 Virginia Tax Rev. 313 (2005), doi: 10.2139/ssrn.742525.

⁷ On the Addendum see Sol Picciotto, *A Fresh Start: Searching for Consensus in International Tax Reform*, 117 Tax Notes Int'l 207 (13 Jan. 2025), doi: 10.2139/ssrn.5106218; Sunita Jogarajan, *Stamp, Seligman and the Drafting of the 1923 Experts' Report on Double Taxation*, 2013 WORLD TAX J. 368 (Oct. 2013), doi: 10.59403/szqg31.

It will, for example, be realised that the obligations of the country that has a factory producing goods and selling them within the country is greater than those of one which confined its activities to selling goods but not producing them in the country. Similarly, in the converse case, the obligations of a concern performing all the economic stages within a country would be greater to that country than if it merely performed the first of them but all the remainder elsewhere. If it is desired by the Financial Committee of the League or by the other committee of officials charged with the consideration of this subject, we should be prepared to develop further ideas on the principle involved.⁸

Clearly, as the Addendum states, this is based on US state formula apportionment (FA), which Seligman was familiar with. By 1923, over twenty US states used FA to divide the corporate income tax base among themselves. Most of them used the 'Massachusetts formula' of tangible assets, payroll, and sales.⁹ These are also some of the factors mentioned in the Addendum as candidates for inclusion in the formula.

Seligman would have been aware of the problems of FA. First, if different countries adopt different formulas, double taxation could result. That is why the Addendum does not make a recommendation, but refers the matter back to the League, which could develop an agreed upon formula.

Second, if some countries choose not to tax income sourced within them by the formula, double non-taxation will result. This could be averted by a rule putting such income back into the pool to be shared by the other states, but Seligman may have thought such a recommendation would be controversial since unlike the US and the UK, most European countries were territorial and did not tax foreign source income even if there was no source-based taxation.

More fundamentally, Seligman believed in ability to pay taxation for individuals, since for them distributive taxation makes sense, as well as taxation with representation based on voting. It makes less sense for the corporate tax since a corporation does not bear the burden of the tax, and the incidence of the corporate tax is still undetermined despite decades of research by economists. Moreover, the residence of corporations is not a meaningful criterion for taxation, especially not under the US rule of place of incorporation, and therefore source based corporate taxation makes more sense than residence-based taxation, even if it leads to double non-taxation.

The League responded by studying the issue, but unfortunately, it ultimately did not follow this recommendation in its study of methods of allocating profits among taxing jurisdictions.¹⁰ Instead, it adopted the Arm's Length Principle (ALP). There was nothing in the Report or the early models that resembled the ALP, and countries were free to follow the US states and apply FA. This is what France did for both branches and subsidiaries.¹¹ But in 1932, the US objected to the application of FA to French subsidiaries of US multinationals, and was able to force France (e.g., by adopting section 891, the original 'revenge tax', in 1934) to ratify a treaty including for the first time the ALP.¹² The ALP was the invention of Mitchell Carroll, the US treaty negotiator and later US representative to the fiscal committee of the League of Nations (whose work was financed by the Rockefeller Foundation even though the US was not a member of the League).¹³ Carroll was also responsible for interpreting the predecessor of section 482 to incorporate the ALP in regulations in 1935 and in persuading the League to include the ALP in the 1935 model convention, although it also included an FA option.¹⁴

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⁸ Report, Addendum.

⁹ See US House of Representatives, *State Taxation of Interstate Commerce, Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary pursuant to Public Law 86-272 as amended* (Edwin Willis, chair), Vol 1, 88th Cong., 2d Sess., H.R. 1480 (1964) and 89th Cong., 1st Sess., H.R. 565, 1:952 (1965).

¹⁰ Sunita Jogarajan, *The League of Nations and International Tax in the 1930s*, U of Melbourne Legal Studies Research Paper Forthcoming (21 Dec. 2022), Available at SSRN <https://ssrn.com/abstract=5147114> or <http://dx.doi.org/10.2139/ssrn.5147114>. The International Chamber of Commerce was heavily involved in the League's work on this topic.

¹¹ So did Germany and other European countries. See e.g., the German National Report, which said that 'it may be said that the method of fractional apportionment (Verteilung) is preferable, both from the viewpoint of fairness, which is identical with just taxation, and from the viewpoint of diminishing as much as possible double taxation'. See League of Nations, *Taxation of Foreign and National Enterprises*, 1 (1935).

¹² Convention and Protocol Between the United States of America and France, Signed at Paris, 27 Apr. 1932, Art. IV: When an American enterprise, by reason of its participation in the management or capital of a French enterprise, makes or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with a third enterprise, any profits which should normally have appeared in the balance sheet of the French enterprise, but which have been, in this manner, diverted to the American enterprise, are, subject to the measures of appeal applicable in the case of the tax on industrial and commercial profits, incorporated in the taxable profits of the French enterprise. See Mitchell B. Carroll, *The Development of International Tax Law: Franco-American Treaty on Double Taxation – Draft Convention on Allocation of Business Income*, 29 Am. J. Int'l L. 586, 590 (Oct. 1935), doi: 10.2307/2190885; Avi-Yonah, *The First US Tax Treaty and Its Influence*, 52 Intertax 5 (2024), doi: 10.54648/TAXI2024001; Avi-Yonah, *Should the Arm's Length Standard be Codified?* 52 Intertax 828 (2024), doi: 10.54648/TAXI2024083.

¹³ It is possible that Carroll was familiar with German legislation from 1925 that prefigured the ALP, stating that 'If, as a result of special agreements between the taxpayer and a party not subject to unlimited taxation, the profit of a domestic trade or business is clearly not in proportion with the profit that would otherwise be achieved in business transactions of comparable or similar nature, said profit, or at least the usual return on capital serving this trade or business, can be taken as the basis for determining the income of the domestic trade or business'. See German Reichstag, Drucksache, 27 Apr. 1925 – III 1924/25 no. 795, Reichssteuerblatt (RStBl, German Tax Gazette) 1925, 196. It is interesting that the German legislation focuses on profits rather than prices, preceding by many years the Comparable Profits Method. But its language does not define what is meant by 'business transactions of comparable or similar nature', and the reference to 'the usual return on capital' opens the door to the asset-based formula used by France that Carroll wanted to reject. In fact, the German legislation could be (and was) used to apply an apportionment method. This was supported by the concept of Organschaft in German law, which treated a subsidiary that was part of an integrated business as taxable in Germany. See Sol Picciotto, *International Business Taxation* 181–182 (Weidenfeld and Nicolson 1992).

¹⁴ See League of Nations, *Taxation of Foreign and National Enterprises*, 1 (1935).

From these beginnings the ALP became a standard feature of the international tax regime, included in every tax treaty, and in 2010 the US and the OECD deleted Article 7(4) and Article 14, which were the last remnant of FA in their models, and adopted the ‘Authorized OECD Approach’, which applied the ALP to branches as well as subsidiaries.¹⁵

However, as all the subsequent history has demonstrated, the ALP is unworkable in practice because the main reason multinationals exist is that they have unique advantages (such as ‘crown jewel’ intellectual property) over unrelated parties that would be lost if the parent did not control the subsidiary. And that in turn means that in the most important cases, comparables do not exist, and the ALP cannot be implemented.¹⁶

Therefore, I have advocated for over thirty years that the US and the world abandon the ALP and replace it with a FA regime.¹⁷ Until 2021, the US and the OECD vehemently resisted such a move. But in adopting Pillar One with US consent in 2021, the OECD conceded that for extraordinary returns of the largest multinationals, FA is the only viable option.

Pillar One is now dead because it depends on the Multilateral Convention (MTC) coming into effect, and that cannot happen under its terms without US Senate ratification, which is very difficult to imagine since it requires a bipartisan vote of sixty seven senators.¹⁸

But it is precisely the demise of Pillar One that may open the door to a widespread adoption of FA. With no Pillar One, countries are free to adopt the Amount A formula unilaterally, since the data necessary to implement the formula is publicly available. All that a country needs to know is the global profit of the relevant multinational, which can then be allocated to that country based on local assets, payroll, and sales or users. And this formula does not need to be limited to Amount A or to the largest multinationals; it can be applied to all the profits of all the multinationals that have assets, payroll, or sales in the country. India came close to adopting such a formula unilaterally before 2021.¹⁹ Moreover, like all countries that derive their law from the UK, India can override treaties that contain Articles 7 and 9, which mandate application of the ALP (although many treaties also include Article 7(4), which permits FA for branches).²⁰ Most countries in the world can override treaties or (in the case of Africa) have few treaties. Even the EU can override treaties by directive.²¹

Alternatively, the UN is now beginning to negotiate a new international tax regime that is more legitimate and less skewed toward developed countries, and it is free to adopt FA on a multilateral basis, at least as one alternative.²² After all, countries are free to choose either credit or exemption regimes and either the PPT or the LOB under the existing rules. There is no reason they should not be able to choose either the ALP or FA.

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¹⁵ See Avi-Yonah & Zach Pougá Tinhaga, *Unitary Taxation and International Tax Rules*, in *International Taxation: Law and Practice in Hong Kong and China* 19 (J. Chaisse & M. Lang eds, Kluwer 2015).

¹⁶ For early critiques of the ALP see Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, Tax Notes 17 Feb. (1986); Sol Picciotto, *International Business Taxation* (Weidenfeld and Nicolson 1992).

¹⁷ See e.g., Avi-Yonah, *Slicing the Shadow: A Proposal for Updating US International Taxation*, 56 Tax Notes 1511 (15 Mar. 1993); Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation*, 15 Virginia Tax Rev. 89 (1995); Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Texas L. Rev. 1301 (1996), doi: 10.2139/ssrn.3920264; Avi-Yonah & Kimberly Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, (The Hamilton Project, Brookings Institution 2007); Avi-Yonah, Clausing & Michael Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. 497 (2009), doi: 10.2139/ssrn.1317327; Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 World Tax J. 3 (2010), doi: 10.59403/3d0ngwz; Avi-Yonah & Ilan Benshalom, *Formulary Apportionment – Myths and Prospects*, 3 World Tax J. 371 (2011), doi: 10.59403/1nseyd0.

¹⁸ See Avi-Yonah, *After Pillar One*, 3 Brit. Tax Rev. 243 (2023), doi: 10.2139/ssrn.4956301; Avi-Yonah, *The Usefulness of Pillar 1*, 115 Tax Notes Int'l 1205 (19 Aug. 2024), doi: 10.2139/ssrn.4956301.

¹⁹ See Avi-Yonah & Ajitesh Kir, *India's New Profit Attribution Proposal And the Arm's-Length Standard*, 93 Tax Notes Int'l 1183 (17 Jun. 2019), doi: 10.2174/1570159X1712191028162706.

²⁰ See Avi-Yonah & Pougá Tinhaga, *supra*, n. 16.

²¹ See Avi-Yonah, *Pacta Sunt Servanda? The Problem of Tax Treaty Overrides*, 2022(1) Brit. Tax Rev. 15 (2022), doi: 10.2139/ssrn.4098235.

²² See Avi-Yonah, *Whither the UN Framework Convention?* Int'l Tax J. 34 (Dec. 2024), doi: 10.2139/ssrn.5014213. The 1935 League of Nations draft multilateral conventions offered both FA and the ALP as alternatives.