

FOREIGN AND NATIONAL ENTERPRISES

(Volume IV)

METHODS OF ALLOCATING TAXABLE INCOME

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REPORT ON METHODS OF ALLOCATING TAXABLE INCOME

PREFACE

The present report to the Fiscal Committee forms the conclusion of a long enquiry into the taxation of foreign and national enterprises in thirty-five countries, most of which were visited by the author, Mr. Mitchell B. CARROLL, who was entrusted with this mission by the Fiscal Committee. This report is based both on the information contained in the reports on the tax law of the different countries, published in the previous volumes of this collection,¹ and on the data which the author obtained on the spot or by correspondence from the administrations, and professional and business organisations.

The first eleven chapters of this report constitute a digest of the present legislation, jurisprudence and practice of the States covered by the enquiry, with regard to the allocation or apportionment of the income of enterprises operating in several countries.

In the twelfth and last chapter, the author sets forth the practical conclusions resulting from this general survey. Taking into account both the legitimate requirements of fiscal administrations and the needs of industry and international trade, he endeavours to formulate a system of allocating or apportioning the income of business enterprises which would be fair, practical, logical and suitable for all types of undertakings.

Because of the plan followed, this survey shows in what way the existing laws of the different countries might be modified with a view to preventing the double taxation resulting from conflicts in principles and methods of allocating the income of enterprises. Moreover, as this report constitutes a synthesis of the experience of a large number of countries, it may possibly serve as a guide to fiscal administrations when they are faced with certain special cases that have already arisen and been settled in other jurisdictions.

In the draft convention on allocation drawn up at its last session, the Fiscal Committee relied largely upon Mr. Carroll's work. As that draft only prescribes general principles, the Committee stated that Mr. Carroll's report — although all the views expressed therein are not necessarily shared by each of its members — might usefully be consulted " as a guide in applying those principles to the complex cases that arise in practice ".²

The author has acknowledged to us his gratitude to the officials of the fiscal administrations who assisted him in his task. The names of those experts will be found at the head of their studies, which have been published in previous volumes of this collection. He also received generous

¹ " Taxation of Foreign and National Enterprises ", Vol. I (France, Germany, Spain, the United Kingdom and the United States of America), document L.o.N. C.73.M.38.1932.II.A.; Vol. II (Austria, Belgium, Czechoslovakia, Free City of Danzig, Greece, Hungary, Italy, Latvia, Luxemburg, Netherlands, Roumania and Switzerland), document L.o.N. C.425.M.217.1933.II.A.; Vol. III (British India, Canada, Japan, Mexico, Netherlands East Indies, Union of South Africa, States of Massachusetts, New York and Wisconsin), document L.o.N. C.425 (a). M.217 (a). 1933.II.A.

² Cf. Report of the Fiscal Committee to the Council, on its fourth session, document L.o.N. C.399.M.204. 1933.II.A.

assistance from the International Chamber of Commerce. Not only did he have the valuable co-operation of M. JULLIARD, Chairman of the Permanent Committee on Double Taxation of that institution, and of M. Virgilio DEL RIO, Director of its Financial, Commercial and Industrial Section, but he was also given by the National Committees of the Chamber, in various countries, helpful suggestions and information drawn from the practical experience of their members. In particular, the National Committees of Austria, Belgium, France, Germany, Greece, Italy, Japan, the Netherlands, Spain, the United Kingdom, and the United States of America rendered him the greatest assistance. Experts, too numerous to be mentioned by name, belonging to organisations such as the National Tax Association of the United States and the American Institute of Accountants, also furnished the author with material and suggestions of the highest theoretical and practical value.

Nevertheless, it would be unjust not to mention Mr. Henry B. FERNALD and Mr. James R. KNAPP, whose memoranda on certain complex aspects of the problems considered have merited the special attention of the Committee. It is also necessary to thank Professor Ralph C. JONES, of Yale University, for his study on "Allocation Accounting of the Taxable Income of Industrial Enterprises",¹ in which he expresses his views on accounting methods which might be used to carry out some of the principles set forth in this work.

In conclusion, I should like to recall the memory of Professor Thomas S. ADAMS, to whom the Fiscal Committee paid a solemn tribute at its last session. Professor Adams, was the member of the Committee who initiated the present enquiry. Thanks to his zeal and vast knowledge, he was a constant inspiration and guide to those who collaborated in the enquiry.

Hans BLAU,
President of the Fiscal Committee.

¹ "Taxation of Foreign and National Enterprises", Vol. V; League of Nations document C.425(c).M.217 (c).1933.II.A.

CHAPTER I.

THE PROBLEM OF ALLOCATION.

1. The most important kinds of enterprises which give rise to problems in allocating taxable income are industrial and mercantile companies. Banks are next in importance. Relatively few difficulties arise in connection with insurance, transport, power, light and gas, telegraph and telephone, and mining enterprises. The major number of questions are presented by industrial enterprises in the United States of America, the United Kingdom, Germany and other European countries, and Japan, which manufacture in those countries and sell in the territory of other countries throughout the world. This situation is complicated if they produce certain raw materials in countries like British India, Netherlands East India or Spain, using the raw materials in manufacturing in another country, and then selling the finished article throughout the world. Another important question is presented by enterprises which purchase raw materials in countries like British India and Java and sell them on the world markets ; and still another by enterprises which purchase finished articles in one country and sell them in another.

2. Within these broader classifications, sub-classifications must be made of the articles involved, because the relative importance of sales activities compared with manufacturing differs greatly. Whereas the profits of enterprises selling automobiles, typewriters and similar articles in which there is keen competition, or branded articles which must be brought to the attention of the public through skilful advertising, depend, to a great extent, on the sales efforts, other articles, such as scientific instruments, are purchased largely because of their reputation for superior quality gained through years of careful manufacturing.

3. There are practically no two businesses of exactly the same type, size or organisation. Each enterprise reflects the brain and personality of its owner or its principal officers, and the profits depend largely on their initiative, skill and wisdom. The factors conducing to profits vary with each enterprise. It is extremely difficult therefore to decide on the best methods of sub-classifying industrial and commercial enterprises in order to consider in sufficient detail methods of allocation or apportionment applicable to them. Some are small in size and simple in structure, as, for example, those purchasing in one country and selling in a second, or manufacturing a single product in one country and selling it in that country and also in a second. Other enterprises complete their manufactured line of goods by articles which they purchase, and market them all at their selling establishment in the second country. Still others manufacture many different products for sale in large lots, or retail. The combinations are numberless.

4. The general tendency of international business enterprises is towards a more complex structure. It becomes more and more frequent for a large enterprise to produce its own raw material which is used in manufacture (*e.g.*, rubber, minerals). Moreover, the number of articles which the enterprise itself produces usually becomes more and more varied in order to meet the needs or tastes of customers in different countries. The existence of tariff walls often makes it expedient to assemble within the country partially manufactured goods, or even to manufacture the entire

product there, but using tools or certain raw materials sent from the home factory. Because of legal requirements or expediency, or merely to facilitate the segregation of activities within the country, foreign enterprises often form a local subsidiary company. Although many large enterprises scrupulously treat such subsidiary companies as independent entities, it is the practice of others to regard them in fact as mere branches of the entire concern and to incorporate their earnings in the annual accounts of the entire enterprise, just as if they accrued directly to it. Tax-collectors complain that sometimes enterprises take the rate of tax in various countries into consideration, and fix the transfer price from the factory to a selling establishment at so high a figure as to show little or no profit in the books of the sales branch. Through the arbitrary fixation of inter-establishment billing prices or charges for interest, royalties, services, etc., profits can be shifted from place to place, the purpose frequently being to transfer them to the country with a low rate of tax or no income-tax at all.

5. Often, when an enterprise has branches or subsidiaries in each of several adjacent countries, it establishes at a central point an office to supervise their activities. From it, accountants, engineers, salesmen or other employees may go to the different establishments, in order to serve them in one way or another. The central office may compile statistics on sales possibilities in neighbouring countries or direct an advertising campaign for the benefit of the various sales offices. Sometimes the foreign enterprise maintains, on an important *boulevard* — for example, the Champs-Élysées in Paris, or the Board Walk in Atlantic City — imposing displays of its products in order that they may catch the eye of the transient visitor, who may purchase the product from the local sales branch when he returns to his own home. In none of these cases just described does the establishment in question make any sales or directly realise any profit. Yet all these activities constitute items of expense, and contribute in one way or another to the realisation of profit somewhere by the enterprise.

6. The central accounting of the enterprise should show whether or not, as a whole, the enterprise has realised a profit or loss, and it is probable that every well-run concern maintains accounts for the various units which will enable it to determine whether or not each is a "paying proposition". The tax official in each country where there is an establishment has at his immediate disposal only the accounts (if any) of the local establishment, and it is necessary for him to ascertain whether or not they reflect the true profit attributable to that establishment. Obviously, his task is easy if the local establishment is virtually self-contained or is an autonomous unit which is treated as such by the foreign enterprise, or if the foreign enterprise has dealt with each establishment at arm's length as if it were an independent enterprise. This entails, in some cases, allotting to it the capital normally required to carry on its activities, and, in every case, billing to it or making charges at the same rates as it would to an outsider. Unfortunately, however, the local establishment is not so treated by the great majority of enterprises, and the tax inspector finds it necessary to adjust the accounts after securing whatever additional information is available or to make an assessment on an empirical or fractional basis.

7. Cases arise where the taxpayer has tried meticulously to allot profits in a fair way between the various establishments, but the authorities of the several countries are of a different opinion as to their share of the taxable income. It may happen that one country to which the taxpayer has thrown a large share of his profits will assess tax thereon, and then another country in which little profit is shown will increase the assessment and thereby subject a part of the profit to double taxation. The natural tendency of each tax administration is to view the local establishment as exercising the most important influence in the production of profits and therefore ascribe to it a commensurate share of the income. When all the assessments are added together, the enterprise finds that it has paid taxes on much more than 100 per cent of its net income. Incidentally, it has had to argue with the authorities of each country in regard to the amount of profit allocable

thereto, and possibly has had to produce copies or extracts of its head-office accounts in order that the authorities of each country may examine the local accounts in the light thereof. This all requires expenditure of time and money on the part of the taxpayer as well as that of the tax-collector.

8. As there exists little law and less jurisprudence concerning allocation, tax administrations are inclined to broaden the basis of assessment of foreign and national enterprises to the largest extent possible, and thereby encroach upon the jurisdiction claimed as well by other States, which results in the accumulation of high rates upon the same profits. The fiscal administrations thus combine to impose a crushing burden upon the very commerce which other Government departments and business groups are endeavouring to encourage.

9. The subject of allocation may be described as being at the cross-roads of all the sciences. It involves not only the fiscal sovereignty of States, and civil, commercial and sometimes penal law, but also commercial geography, economics, business management, and — last, but not least — accounting. When one peruses the great books on public or private international law, one finds little said about the limitations of fiscal sovereignty. In most countries, the tax laws have restricted jurisdiction, on the one hand, to nationals or persons domiciled or resident within the country, and, on the other, to income from sources situated within the country. In many instances, however, the recognition of this sound principle has been in effect nullified by the definition of the source of income — for example, by regarding the sale within the country as the sole source of income, thus making no allowance for profit accruing to manufacture or production abroad. If, however, the foreign companies themselves endeavour to obviate the excessive burdens which such laws impose, they not infrequently incur heavy penalties.

10. Fiscal policy is influenced to an incalculable degree by the economy of countries. Each country wishes to encourage its own industries. At the same time, the tendency of the fiscal administration is to impose the heaviest taxes on the most conspicuous and important sources of revenue. As a result, one finds countries productive of raw materials trying to reach the whole of the profit derived from the extraction and sale on world markets of their metals, oil, rubber and the like. Some countries tax the whole of the profit derived from manufacturing within their territory and selling abroad. Not a few countries, into which the foreigner comes to sell his products, tax, in principle, the whole of the net profit above the actual cost of the goods and the expense of selling them. Curiously enough, it is countries which are most dependent upon the production of raw materials and their sale abroad, like British India, Mexico and Cuba, which endeavour in their law and practice to tax the whole or most of the profit realised by foreign enterprises selling in the local market the manufactured and finished articles which they need.

11. In its broadest aspects, the problem of allocation is not limited to the distribution of what might be termed business profits to the various countries in which an enterprise operates. An industrial and commercial enterprise often invests its reserve funds in stocks and bonds. It may license patents to other companies. It may own buildings, which are rented entirely or in part to others. A company may own a mine or a mining concession in another country which it leases to a second company for exploitation. A personal service corporation may receive compensation for the services of its employees in other countries. Income may be derived from the sale in a given country of capital assets, whether real or personal property. The corporation may do business in some countries through regular commission agents, in others through agents remunerated on a commission basis, in others through independent dealers, and, in still others, through its own branches.

12. The method of financing operations through each of these agents, dealers or branches will, in all probability, vary, with consequent effects on prices and interest charges. In the case of the regular commission agent or the agent remunerated by a commission, the company usually retains ownership of the goods and has its capital tied up in them until they are sold. If the goods are sold to a dealer who resells them for his own account, the price of the goods depends largely upon whether the dealer pays for the goods immediately or is receiving them on credit, and whether the dealer is carrying the cost of advertising or the cost in that market is borne by the manufacturer. If the enterprise is operating through a branch, the latter must obviously, in accordance with its nature, have a certain working capital, and this must either be advanced by the head office or borrowed. The funds may be borrowed either from a bank in the country of the head office for the use of the branch, or borrowed directly by the branch from a local bank. It is needless to list the various items of income or expenditure that will vary from enterprise to enterprise, and will appear in the books of the head office and possibly in those of the branch involved.

13. Although the banking business is, in general, more standardised through the control of bank examiners in the country of the head office or of the branches, nevertheless the requirements of banking laws differ and the practices in important countries differ. Some countries permit the local branch of a foreign bank to receive deposits and carry on all banking operations, whereas others do not permit them to take deposits, although, through its branch, the foreign bank may discount bills of exchange and make loans.

14. The laws in various countries concerning insurance companies differ in regard to their requirements as to reserves, and the method of taxing such companies varies greatly. Likewise, transport and other public utility enterprises are generally subject to a special control, exercised either by a Government department or through the terms of a concession. The allocation of the income of the previously mentioned and other types of enterprises is complicated, not only by the diversity in their methods of operation, but also by the incredible differences in the tax laws of the various countries. No two income-tax systems are exactly the same, and it is impossible to classify them. Even in the States of the United States of America and in the cantons of Switzerland, the legislatures have expressed their individuality in their tax laws. Generalisations are dangerous even in describing a single system, because, even though it may have originally been based on one or two broad principles, during the course of years successive legislatures have introduced exceptions to this or that principle, with the result that it is hard to disengage the fundamental precepts of the system.

15. Obviously, a regime for the allocation of income as between countries must take into consideration these divergent or conflicting principles and provide for the allocation or apportionment of items of income or expense to the various jurisdictions concerned therewith. It is impossible to avoid the task of synthesising as far as possible the underlying principles of the different systems and the methods of taxing the principal items of income.

16. This problem may be approached from two angles : (1) that of foreign enterprises, and (2) that of national enterprises.¹ Although the same principles of allocation may be employed for

¹ In general, a foreign enterprise is an enterprise belonging to a non-resident individual, a partnership composed of non-residents, or a non-resident corporation. A national enterprise is an enterprise belonging to a resident individual, a partnership composed of residents, or a resident corporation. The test of residence of a corporation varies from country to country, but, in general, it is the place where its real centre of management is located. In some cases, the situation of the statutory seat is decisive. In other countries, notably the United States of America and Mexico, a corporation is foreign if organised abroad, and national if organised in or under the laws of the country. For definitions of "foreign and national" enterprises, see Part II of the descriptions of tax systems in "Taxation of Foreign and National Enterprises", Vols. I, II and III.

both categories, the question of foreign enterprises is discussed first because they have given rise to many more problems of allocation. Most Governments have not been especially concerned with the allocation of income to their home enterprises, because they tax them on total net profit. Where relief from double taxation is granted, the enterprise bears the burden of proving the amount of the foreign tax paid and the amount of foreign income. The tax inspector, as a rule, has at his disposal the accounts of the entire enterprise and is therefore in a position to verify the income allocable to his own or a foreign jurisdiction. If the taxpayer organises in a foreign country a subsidiary to which it shifts profits through artificial invoice prices or otherwise, the officials are usually able to circumvent this in the long run because of the availability of necessary data at the head office.

17. On the other hand, the tax official in the country of the branch or the subsidiary is at a disadvantage. All that he has at hand is the accounting of the local establishment and the data pertaining to the income of similar enterprises, if any. Even if he secures statements as to the concerns of the entire enterprise as shown in the books of the head office in another country, they are, even if translated into his own language and currency, usually in such an abbreviated form that it is almost impossible for him to compute accurately, or even to estimate, the profit allocable to the local establishment. Consequently, administrations have developed the methods of assessment on empirical or fractional bases which are subsequently described.

18. When he examines the accounts of the local establishment, the inspector may find listed, depending on the nature of its activities, items of income such as interest or dividends from local or foreign securities, interest on loans to persons within or without the country, rent from real estate situated within or without the country, royalties for the use of patents, copyrights, trade marks, secret processes or formulae by persons within or without the country, compensation for services rendered within or without the country, receipts from the sale of capital assets within or without the country, receipts or receivables from sales of goods or merchandise which have been concluded within or without the country. Among the liabilities indicated in the local books, he may note interest payments to the head office or to local banks, or other persons — possibly on short-term indebtedness, secured or unsecured, or possibly in respect of a loan secured on real estate owned by the enterprise within the country. The inspector may also find salaries, commissions, or other compensation for services rendered within or without the country, amounts paid or payable for goods or merchandise received, and the numerous items of expenditure incident to running an establishment. If the local establishment is a subsidiary company, its books are more likely to show charges for interest, and they may also show patent and copyright royalties paid to the parent company, charges for services, and other items which the parent or associated companies might more readily make to a separate legal entity. Most of these items of income and related expenses are subject to specific legislative provisions stating whether they are definitely allocable for taxation within the country or are to be excluded from the assessment. Thus the United Kingdom Income-Tax Act of 1918 contains five Schedules imposing liability on non-residents in respect of all income arising in the United Kingdom, but prescribing detailed rules for assessment under the five Schedules: (A) Income from the ownership of lands, houses, etc. ; (B) Income from the occupation of lands ; (C) Income paid under deduction of tax at the source out of any public revenue ; (D) Income from trades, professions and vocations, foreign securities and possessions, interest, and miscellaneous items of income ; (E) Income from employments. Whereas the non-resident company is subject to the British standard rate of tax, the non-resident individual is liable to the surtax in respect of the United Kingdom income.¹

¹ "Taxation of Foreign and National Enterprises", Vol. I, page 169.

19. The French Government imposes eight separate and distinct schedular taxes (*impôts cédulaires*): (1) tax on income from buildings, (2) tax on income from lands, (3) tax on income from movable capital (*impôt sur le revenu des capitaux mobiliers*), (4) proportional charge on mines, (5) tax on industrial and commercial profits, (6) tax on agricultural profits, (7) tax on salaries, wages, pensions and annuities, (8) tax on profits from non-commercial occupations. Except for the tax on income from movable capital, these levies are imposed in accordance with the principle of territoriality — that is to say, only in respect of the income from various sources situated in France. The tax on income from movable capital, however, is imposed in respect of dividends and interest on foreign securities which are either paid in France or received by persons domiciled in France.

20. The Belgian and Italian systems both have schedular taxes, but, whereas the Italian system adheres rather closely to the principle of territoriality, the Belgian schedular taxes are imposed at a reduced rate on income from foreign sources. Special methods of taxation, or special taxes on particular items of income, are found in most of the other European countries and in Japan, Cuba and Mexico. Wherever possible, income is taxed by withholding at the source, notably in the case of dividends, interest and salaries. Interest and dividends are usually taxed on their gross amount. On the other hand, the United States of America taxes the non-resident alien or foreign corporation on its net income from United States sources. The items of income from the various sources in the United States are lumped together and expenses incurred in reference to this income are deductible. Nevertheless, the Act specifically defines sources within and without or partly within and partly without the United States.¹

21. Consequently, it is possible under the laws of most countries to allocate many of the above items of income and related expenses to sources defined as being within or without the given jurisdiction. This is possible in respect of practically all items other than income from dealing in goods or services in two or more countries. Moreover, the question of tax jurisdiction over most of these items of income, except income from international business, has been definitely settled by bilateral treaties for the prevention of double taxation between many of the European countries.²

22. Although the legislative or treaty provisions regarding these different items of income vary considerably, in the majority of cases it is provided, for example, that interest shall be allocated to the country of the debtor, dividends to the country in which the distributing corporation has its seat, rents and other income from real estate and interest on loans secured by mortgages thereon to the country in which the real estate is situated, and compensation for personal services to the country in which the services are rendered. Although most tax laws hold royalties liable to tax in the country of the payer, some of the treaties allocate them to the country of domicile of the recipient licensor for tax purposes.

23. With regard to income from dealing in goods or services, which may be briefly referred to as "business income", the tax inspector is not provided in most instances with guiding criteria or methods of allocation. In general, the foreign enterprise is subjected to the same provisions concerning gross income and allowable deductions as are national enterprises. These provisions, and especially those concerning the allowable deductions, differ greatly from country to country. This is especially true in regard to allowances for depreciation, depletion, bad debts and losses from the sale of capital assets. The differences are too numerous to list. If the taxpayer has so carried on the operations of the local establishment that its taxable income may be readily determined by

¹ *Infra*, paragraph 58 *et seq.* For a complete description of the structure of the income-tax in the various countries, see Part I of their reports in "Taxation of Foreign and National Enterprises".

² See "Collection of International Agreements and Internal Legal Provisions for the Prevention of Double Taxation and Fiscal Evasion", League of Nations document C.345.M.102.1928.II, and supplements.

reference to the local books, the assessment is easy to make. If, on the contrary, the officials consider it necessary to apportion to the branch a part of the joint income of the local establishment and that of another establishment, as under the Austrian treaties with Czechoslovakia and Hungary, or a part of the total net income of the enterprise, they usually insist that this total net income shall be computed in accordance with the provisions of their own Act. The difficulties inherent in such methods of assessment are obvious, and a predilection for assessment on the basis of the separate accounts of each establishment prevails in the majority of countries. The question presents itself, however, whether the law of a country contains any criteria as to what amount of income derived from dealing in goods or services within and without the country should appear in the local books.

CHAPTER II.

LEGAL PRINCIPLES FOR ALLOCATING BUSINESS PROFITS.

INTRODUCTION.

24. Laws seldom define specifically the circumstances in which income from industry or commerce accrues or arises. Although the wording of the basic provisions concerning liability varies greatly from country to country, broadly speaking there are three general precepts with regard to a foreign enterprise : (1) that it is taxable on profits from carrying on a trade or business within the territory of the State, (2) that it is taxable in respect of income attributable to a permanent establishment in such territory, and (3) that it is liable in respect of income from sources within such territory. The first prevails quite generally in countries of the British Commonwealth of Nations, the second in continental European countries and their dependencies, and the third in the United States of America. Interpretations vary as to what constitutes trading within the country, or a permanent establishment, or whether income from certain transactions is from sources within the country.¹

25. In dealing with national enterprises, on the contrary, most of the countries in all three groups tax, in principle, their entire net income. To prevent double taxation, however, a number of these Governments, in their fiscal legislation or in bilateral treaties, either grant certain relief against their own tax in respect of taxes paid abroad on the income of a foreign establishment or exempt such foreign income.²

BRITISH COMMONWEALTH OF NATIONS.

United Kingdom.

26. A non-resident is liable to the United Kingdom Income-Tax Act if he carries on a trade there, and the original meaning of this concept is given in a decision rendered in 1860. It reflects the liberal attitude that prevailed in a country which had at that time a profound belief in free trade. In the case of *Sulley v. Attorney-General*,³ a firm established in New York bought goods in the United Kingdom and other countries for the purpose of sending the goods to America and selling them there. The New York firm had a branch establishment in Nottingham which was conducted by a partner. The question was whether there was a carrying-on of trade in the United Kingdom which would give rise to liability for the partners residing in America as well as the partner resident in the United Kingdom. Chief Justice Cockburn held that liability to the income-tax

¹ For a detailed discussion of these principles of liability, see Parts I and II of the reports of the various fiscal administrations in "Taxation of Foreign and National Enterprises".

² *Intra*, paragraph 568 *et seq.*

³ 1860, 5 H. and N. 711, 2 T. C. 149.

attached only to such profits as were derived by the partner resident in the United Kingdom, supporting his view with the following language :

“ Wherever a merchant is established, in the course of his operations his dealings must extend over various places ; he buys in one place and sells in another. But he has one principal place in which he may be said to trade — viz., where his profits come home to him. That is where he exercises his trade. It would be very inconvenient if this were otherwise. If a man were liable to income-tax in every country in which his agents are established, it would lead to great injustice. The argument for the Crown must be carried to this extent, that merely buying goods in this country is a trade exercised here so as to subject the purchaser of the goods to income-tax. In the present case, the defendant is a partner ; but, if the argument is well founded, this American firm might be taxed in the same way if he had been merely an agent. It would be most impolitic thus to tax those who come here as customers. The subjects of a foreign State, not resident here, cannot be made amenable to our laws. How then are their profits to be made amenable to the fiscal law ? Simply by the provision that whosoever carries on the business and receives the profits here shall be assessed. But, in the present case, no profits are received by the firm, or exist in this country. . . . The profits of the firm in America do not accrue in respect of any trade carried on in this country, but in respect of the trade carried on in New York where the main business is conducted. The profits which come home to this country as the share of the individual partner here are taxable ; as to the main profits which go into the pockets of the partners in America, we think they are not.”

27. One sees in this decision the origin of a number of important principles which were the subject of numerous subsequent decisions. In the first place, it is interesting to observe the emphasis laid on taxation at the principal place where one trades — that is to say, where his profits come home to him. This generally coincides with the residence or fiscal domicile of the taxpayer. In the second place, the decision holds that, when a non-resident merely purchases goods in the United Kingdom, profits do not accrue in respect of any trade carried on there, but in respect of the trade carried on at the place where the main business is conducted. This principle of law is still observed in the United Kingdom.¹ But subsequent English decisions contradict the general proposition that non-residents cannot be made amenable to British law. These contradictory views were expressed in decisions regarding cases where the non-resident did not merely purchase goods in the United Kingdom, but sold there goods which had been purchased or manufactured abroad. The essential test of liability under British tax law is whether or not the non-resident enterprise exercises a trade within the United Kingdom.² This principle was supported by various specific provisions such as that making a non-resident “ chargeable in the name of . . . any factor, agent or receiver having the receipt of any profits or gains arising as herein mentioned. . . .”³ In the light of this provision, it was held in the House of Lords⁴ that a foreign merchant who canvasses through agents in the United Kingdom for orders for the sale of his merchandise to customers in the United Kingdom does not exercise a trade in the United Kingdom so long as all the contracts for the sale and all deliveries of the merchandise to customers are made in a foreign country. Lord Watson observed :

“ There may, in my opinion, be transactions by or on behalf of a foreign merchant in this country so intimately connected with his business abroad that, without them, it could not

¹ “ Taxation of Foreign and National Enterprises ”, Vol. I, page 195.

² See Income-Tax Act of 1842, Chapter 35, Section 41 ; Income-Tax Act of 1853, Schedule D, Chapter 34, Section 2, and similar provisions in subsequent Acts.

³ Income-Tax Act of 1842, Chapter 35, Section 41.

⁴ In *Grainger and Sons v. Gough*, 1896, A. C. 325, 3 T. C. 462.

be successfully carried on, which are nevertheless insufficient to constitute an exercise of his trade within the meaning of Schedule D. In illustration of that view I may refer to *Sulley v. Attorney-General*, which was decided in the Exchequer Chamber by no less than six very eminent judges."

28. Relatively the same viewpoint was expressed in the subsequent case of *Smidth & Co. v. Greenwood*.¹ A Danish firm, resident in Copenhagen, manufactured merchandise there and exported it all over the world. They had an office in London in charge of a qualified engineer who was their whole-time employee. He received enquiries and specifications for machinery, and, when the machinery was supplied, he was available to give the English purchaser the benefit of his experience in erecting it. The contracts between the firm and their customers were made in Copenhagen and the goods were shipped f.o.b. Copenhagen. Judge Rowlatt decided that the place where trade was exercised was the place where the transactions forming the alleged business were closed (in the case of a selling business by the sale of the commodity), and the profit thereby realised. The firm therefore exercised their trade in Denmark and could not exercise their trade elsewhere in respect of the same profits.

29. As the influx of foreign goods into England increased, the trend of the decisions swung in the opposite direction. The network of facts taken by the courts as indicative of trade being carried on in the United Kingdom became more and more closely woven.

30. In determining the liability of a foreign enterprise, it became well established that, although essentially a question of fact, trade was carried on in the United Kingdom through an agent if the contracts for the sale of goods were made in the United Kingdom.² As the communication of an acceptance to an offer concludes a contract, a foreign principal was even held liable because the agent posted his acceptance in the United Kingdom.³

31. To summarise, the basic principles of the British law and jurisprudence are that a resident enterprise is taxable on the whole of its profits, and that a non-resident is taxable on profits derived from the exercise of a trade in the United Kingdom, the principal test of carrying on trade being the conclusion of contracts within that country.

32. The whole of the income from carrying on trade in the United Kingdom is considered to arise there, but the United Kingdom Income-Tax Act, 1918, General Rule 12, gives the taxpayer who manufactures goods abroad and sells them in England the option of having his assessment limited to the "merchandising profit realised in England"⁴ — that is to say, the profits which

¹ 1920, 3 K. B. 275 ; 1921, 3 K. B. 583 ; 1922, 1 A. C. 417, 8 T. C. 193.

² *Maclaine and Co. v. Eccott*, 1926, 10 T. C. 481 at page 574 ; *Wilcock v. Pinto*, 1925, 1 K. B. 30, 9 T. C. 111 ; *Gavazzi v. Mace*, 1926, 10 T. C. 698. See also *Erichsen v. Last*, 1881, 8 Q. B. D. 414, 4 T. C. 422 ; *Werle and Co. v. Colquhoun*, 1888, 20 Q. B. D. 753, 2 T. C. 402 ; *Lovell and Christmas v. Tax Commissioners (New Zealand)*, 1908, A. C. 46. For a discussion of these decisions and legislative provisions to exempt business done even regularly through *bona-fide* commission agents or brokers, see "Taxation of Business in Great Britain", by Mitchell B. CARROLL, published by the United States Department of Commerce.

³ *Belfour v. Mace*, 13 T. C. 539. See "Taxation of Foreign and National Enterprises", Vol. I, page 184, which also quotes the authorisation to conclude treaties for the reciprocal exemption of business done through such intermediaries.

⁴ General Rule 12 reads as follows :

"Where a non-resident person is chargeable to income-tax in the name of any branch, manager, agent, factor or receiver in respect of any profits or gains arising from the sale of goods or produce manufactured or produced out of the United Kingdom by the non-resident person, the person in whose name the non-resident person is so chargeable may, if he thinks fit, apply to the commissioners by whom the assessment is made, or, in the case of an appeal, to the general or special commissioners, to have the assessment to income-tax in respect of those profits or gains made or amended on the basis of the profits which might reasonably be expected to have been earned by a merchant or, where the goods are retailed by or on behalf of the manufacturer or producer, by a retailer of the goods sold, who had bought from the manufacturer or producer direct, and on proof to the satisfaction of the commissioners concerned of the amount of the profits on the basis aforesaid, the assessment shall be made or amended accordingly."

might reasonably be expected to have been earned, according to the circumstances, by a merchant or by a retailer of the goods sold who had bought direct from the manufacturer.

33. As a similar criterion is not provided in the law to cover the case of a non-resident enterprise manufacturing in the United Kingdom and selling goods abroad, the Royal Commission on the Income-Tax, in its 1920 report, stated :

“ We approve of the principle of a division of the profit into manufacturing profit and merchanting profit, and we consider that the converse of this rule (Rule 12) should apply to the British resident agent of a foreigner who purchases goods in this country, subjects them here to processes akin to the processes of manufacture and eventually sends them to his principal abroad. It would then be possible for the foreign principal to make application that the profits assessed in this country should be the manufacturing profit as distinct from the merchanting profit which he makes by selling the goods abroad.”¹

Irish Free State.

34. On the contrary, the Irish Free State has amended the Income-Tax Act, 1918, by adding a provision which has the effect of making all concerns manufacturing or partly manufacturing goods within its territory taxable on the whole of the profits arising from the sale of such goods, irrespective of the place of control and irrespective of the place in which the sales are brought about.²

British India.

35. The British India Income-Tax Act of 1922, as amended, goes still further by rejecting completely the precept of allocation contained in General Rule 12 of the United Kingdom Act. Section 42 (1) provides that in the case of a non-resident :

“ . . . all profits or gains accruing or arising to such person, whether directly or indirectly, through or from any business connection or property in British India shall be deemed to be income arising or accruing within British India and shall be chargeable to income-tax in the name of the agent of any such person. . . . ”

In other words, under a strict interpretation of the law, all the income derived from any business connection in British India is allocable thereto, and, in order to prevent leakage in connection with sales there, Section 42 (3),³ which was subsequently enacted in 1928, states in substance that the whole income derived from the sale of goods in British India shall be deemed not only to arise and accrue but also to be received there (regardless of where, in fact, the payment may have actually

¹ “ Taxation of Foreign and National Enterprises ”, Vol. I, page 195.

² Finance Act, 1923, Section 12 (4), provides :

“ There shall be added to paragraph (a) of Clause 1 of Schedule D of the Income-Tax Act, 1918, the following sub-paragraph :

“ (iv) To any person, whether a citizen of Saorstát Eireann or not, although not resident in Saorstát Eireann, from the sale of any goods, wares or merchandise, manufactured or partly manufactured by such person in Saorstát Eireann ’ ”

³ Section 42 (3) reads :

“ Where any profits or gains have accrued or arisen to any person directly or indirectly from the sale in British India by him or by any agency or branch on his behalf of any merchandise exported to British India by him or any agency or branch on his behalf from any place outside British India, the profits or gains shall be deemed to have accrued and arisen and to have been received in British-India, and no allowance shall be made under sub-section (2) of Section 10 in respect of any buying or other commission whatsoever not actually paid, or of any other amounts not actually spent, for the purpose of earning such profits or gains.”

been made), and that no allocation shall be permitted of any purchasing or manufacturing profits to the foreign country from which the goods came. Problems of allocation are precluded absolutely by the later provision. Thus, a non-resident enterprise which manufactured salt in Egypt and sold it in British India was not allowed to deduct a proportion of the profits which it claimed had been earned by manufacture in the country of origin. Chief Justice Rankin of the High Court of Judicature of Bengal observed that :

“ Profit, though it may be anticipated by valuation or otherwise, is not realised before price, and when an article is sold, the whole profit is realised for the first time.”

He continued :

“ An international convention to limit the rapacity of nations towards the nationals of others might listen to the argument of the assesseees with great respect, but we cannot make room for it in the Indian Act.”¹

36. Thus British India affirms in both its law and jurisprudence the principle that profits arise or accrue only where the sale is made. Nevertheless, Section 42 (1) of its Act, which provides that all profits derived from any business connection in British India shall be deemed to arise or accrue there,² has been held to apply in the case of a non-resident company which merely purchases goods in British India for sale abroad or which processes or manufactures them in British India for sale abroad. In the case of *Rogers Pyatt Shellac Company v. Secretary of State*,³ an American company purchased, at a branch office in Calcutta, gum, shellac and other products for export and sale abroad and also operated a factory in the United Provinces, the products of which were exported and sold abroad. The court held the company taxable, but did not pass on the basis of determining the profit as that question was not before the court. One of the judges indicated, however, that the profits or gains attributable to a business connection in British India might be calculated by fixing a reasonable percentage of the turnover or by some other empirical method authorised by Rule 33 pertaining to the British India Income-Tax Act.⁴

37. In the case of the *Commissioner of Income-Tax, Burma, v. Messrs. Steel Brothers & Company, Limited*,⁵ a non-resident company with headquarters in London worked up rice, cotton and other products in India which were sold abroad, and also purchased certain products and sold them abroad without transformation. The court held that, in so far as liability to income-tax was concerned, no distinction could be drawn between profits on products which had undergone some process of conversion or working up by the taxpayer in India and profits on products purchased by the taxpayer in India and exported in the same form. Although Section 42 (1), read in conjunction with Section 4 (1) of the Income-Tax Act of 1922, provides that all income derived from such business connection in British India shall be deemed to have accrued or arisen there, the

¹ Judgment *in re* the Port Said Salt Association Limited, rendered February 5th, 1932, “ Taxation of Foreign and National Enterprises ”, Vol. III, pages 39 and 40, paragraph 111.

² *Supra*, paragraph 35.

³ 1924, 1 I. T. C. 363.

⁴ Rule 33 reads :

“ In any case in which the Income-Tax Officer is of opinion that the actual amount of the income, profits or gains accruing or arising to any person residing out of British India whether directly or indirectly through or from any business connection in British India cannot be ascertained, the amount of such income, profits or gains for the purposes of assessment to income-tax may be calculated on such percentage of the turnover so accruing or arising as the Income-Tax Officer may consider to be reasonable, or on an amount which bears the same proportion to the total profits of the business of such person (such profits being computed in accordance with the provisions of the Indian Income-Tax Act) as the receipts so accruing or arising bear to the total receipts of the business, or in such other manner as the Income-Tax Officer may deem suitable.”

⁵ 1925, 2 I. T. C. 119.

court held that there should be excluded from assessment a reasonable commission agent's commission on the sale of the products in London.

38. In short, the law provides that all the profit from purchase or manufacture in India and sale abroad is deemed to arise or accrue in British India, but, by virtue of a later decision, some recognition is given to the principle of British jurisprudence that the profit arises or accrues where the sale is made, and consequently a reasonable sales commission is excluded from the profit assessable to the British India tax. It is to be noted that this profit is not what might be termed a sales or merchanting profit, but merely the normal commission that would be payable to a third party for the sale of the goods.

39. The last-mentioned decisions apply only to non-residents and stand out in sharp contrast to another decision which involved a resident of British India. The basic principle of liability to the income-tax of that country is that the tax is imposed on income arising or accruing or received in British India, or deemed to arise or accrue or be received there under the provisions of the Act. If the profits of a resident arise or accrue abroad, they are not taxable unless brought into British India within three years (Section 4 (1) and (2)).

40. In the case of *Jiwan Das v. Commissioner of Income-Tax, Punjab*,¹ the assessee purchased goods through an establishment in British India and sent them for sale to his shop in Kashmir, which is outside British India. It was held that no portion of the profits derived from the sale outside British India which was not received in or brought into British India was assessable. In rendering his opinion, Chief Justice Shadi Lal decided :

“ . . . that the mere purchase of goods in British India was too remote a connection to justify the conclusion that a part of the profits should be held to have accrued in this country”.

41. Under these decisions, because of a statutory presumption, the non-resident is taxed in respect of income from purchases in British India, whereas the resident is exempted. This evidences the need of establishing certain uniform principles of liability to taxation before it is possible to formulate rules of apportionment.

Canada.

42. The principle of dividing the income between the country of manufacture and that of sale, which is optional under the United Kingdom Act, becomes the law in Canada. One of the provisions in its Act² states that, when a non-resident offers anything for sale in Canada, regardless of where the contract may be completed, a proportionate part of the income derived is taxable.

43. Likewise when a non-resident person produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything within Canada, and exports the same without sale prior to its export, a proportionate part of the income derived is taxable³.

¹ 1929, 4 I. T. C. 40.

² Section 27 of the Canadian Income War Tax Act, Chapter 97, R. S. C. 1927, as amended provides :

“ Where a non-resident solicits orders or offers anything for sale in Canada through an agent or employee, and whether any contract or transaction which may result therefrom is completed within Canada or without Canada, or partly within and partly without Canada, such non-resident shall be deemed to be carrying on business in Canada and to earn a proportionate part of the income derived therefrom in Canada.”

³ Section 26 of the Canadian Income War Tax Act, Chapter 97, R. S. C. 1927, as amended, provides :

“ Where a non-resident person produces, grows mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything within Canada, and exports the same without sale prior to the export thereof, he shall be deemed to be carrying on business in Canada and to earn within Canada a proportionate part of any profit ultimately derived from the sale thereof.”

Australia.

44. The contention that no profit or gain can be said to accrue or arise except where manufactured goods are sold was overruled by the British Privy Council in the case of *Commissioners of Taxation v. Kirk*,¹ involving the income-tax of New South Wales, Australia :

“ Under the New South Wales Land and Income-Tax Assessment Act of 1895, Section 15, income-tax was payable in respect of the annual amount of all income :

“ (i) Arising or accruing to any person wheresoever residing from any . . . , trade, . . . carried on in New South Wales . . . ;

“ (iii) Derived from lands of the Crown held under lease . . . ;

“ (iv) Arising or accruing to any person wheresoever residing . . . from any other source whatsoever in New South Wales not included in the preceding sub-sections.”

45. The company was registered in Victoria and had its head office and board of directors in Melbourne. It had mines in New South Wales, where the crude ore was smelted. None of the ore was sold in New South Wales, sales being made for the most part in Melbourne, and the money received for the ore either in London or Melbourne.

46. Their Lordships held that, whether or not the company traded in New South Wales, so as to come within sub-section (i), if there was income, it was clearly income from lands of the Crown held on lease, and so came under sub-section (iii), and also was income from some other source in New South Wales and so came under sub-section (iv).

47. As to whether there was income :

“ It appears to their Lordships that there are four processes in the earning and production of this income : (i) the extraction of the ore from the soil, (ii) the conversion of the crude ore into a merchantable product (which is a manufacturing process), (iii) the sale of the merchantable product, (iv) the receipt of the moneys arising from the sale. All these processes are necessary stages which terminate in money and the income is the money less the expenses attendant on all stages. The first process seems to their Lordships clearly within sub-section (iii) and the second or manufacturing process, if not within the meaning of ‘ trade ’ in sub-section (i), is certainly included in the words ‘ any other source whatsoever ’ in sub-section (iv).

“ So far as relates to these two processes, therefore, their Lordships think that the income was earned and arising and accruing in New South Wales.”

48. The decision in *Commissioners of Taxation v. Kirk* is significant because of its recognition of the principle that income can be earned, or can arise or accrue, through the extraction of ore and the manufacture of goods in one jurisdiction although the goods themselves are sold in another.

CONTINENTAL EUROPE AND DEPENDENCIES.

France.

49. The maintenance of a permanent establishment (*établissement*) in France is the test of liability to industrial and commercial profits tax, and two decisions have been rendered with regard

¹ 1900, A. C. 588.

to the allocation of income — one with regard to a purchasing establishment, the other with regard to a factory. In the former case,¹ the company, with its head office abroad, had in France an office conducted by a special manager which bought goods for resale abroad. The decision held that the operation of this office in itself constituted a commercial enterprise, and that the profit on the resale of goods so purchased was partly due to the conditions of purchase. Consequently, in so far as the company's profits were derived from operations carried out in the French establishment (even if payment were effected abroad) the company was subject to the tax on industrial and commercial profits. With regard to the determination of the profit allocable to a factory in France, the test applied is, What would the factory earn by manufacturing for sale to the other parties the goods which it makes for delivery to the foreign selling establishment?²

Central-European Countries.

50. The precept of permanent establishment is also found in Germany and other Central-European countries, but it has been supplemented by fractional limitations in Austrian and Czechoslovak law and in the Austro-Czechoslovak and Austro-Hungarian treaties. The Austrian laws governing the general profits tax (*Allgemeine Erwerbsteuer*) and the company tax (*Körperschaftsteuer*) prescribe certain definite fractions of income which must be taxed in Austria. These are applicable when an Austrian enterprise maintains permanent establishments in foreign countries, or when a foreign enterprise maintains stipulated kinds of establishments in Austria. The Czechoslovak law embodies similar provisions. More detailed provisions regarding allocation on a fractional basis are embodied in treaties between Austria and Czechoslovakia and Austria and Hungary. Under the Austrian general profits tax law, at least one-fourth of the entire income of an enterprise belonging to an Austrian individual or partnership is taxable, and, under the company tax law, the taxable minimum is one-tenth of the total income. Under the company tax law, if goods are purchased in Austria and sold abroad, or *vice versa*, at least 50 per cent of the net income derived from such transactions is taxable in Austria. If goods are manufactured in Austria and sold abroad, not more than one-third of the joint income from such activities can be allocated to the foreign country. In the above-mentioned treaties, the profits from purchase and sale are divided 50 : 50, whereas the profits from manufacture and sale are apportioned in the ratio of two-thirds to the country of manufacture and one-third to the country of sale.³

Netherlands East India.

51. When faced with a case involving a Dutch company which purchased goods abroad and sold them in Netherlands East India, the Court of Tax Appeals in Batavia undertook, after weighing economic factors, to indicate a percentage representing the profits allocable to Netherlands East India.⁴ In the given case, the head office of the company was in Amsterdam; the board of directors met together and the central book-keeping was maintained there. Furthermore, the whole direction of the buying was exercised there. The company imported into Netherlands East India several articles, subject to a monopoly acquired by the head office. The appellant therefore contended that the possibilities of profit in handling popular monopoly articles lay primarily in the business activities necessary for acquiring the monopolies rather than in the selling organisation. With

¹ Decision of February 14th, 1930 : Dupont's *Bulletin des Contributions directes et du Cadastre*, 1930, page 189 : "Taxation of Foreign and National Enterprises", Vol. I, page 84.

² Decision of the Conseil d'État, July 25th, 1929. "Revue des Impôts sur le Commerce et l'Industrie", by Edouard Maguéro, 1930, No. 2832 ; "Taxation of Foreign and National Enterprises", Vol. I, page 83.

³ "Taxation of Foreign and National Enterprises": for Austria, Vol. II, page 37; "for Czechoslovakia, Vol. II, pages 113 and 114.

⁴ Decision of the Court of Tax Appeals", November 25th, 1931, No. VB/223, "Compilation of Decisions in Netherlands East Indian Tax Matters", No. 655.

regard to free articles, the appellant contended that the profits from handling certain articles — watches and Swiss embroideries — were attributed primarily to the buying activities of the directors, as well as the family relations and close contact between the directors and manufacturers. Consequently, with regard to monopoly articles and special “ lines ” of goods (of which the turnover is about 50 per cent of the total turnover) the nucleus of the profit-making is in Holland. He admitted that, with regard to the other articles, greater weight should be given to the selling organisation in Netherlands East India ; the profit should therefore be divided in the ratio of 50 : 50. In lieu of the preceding “ subjective ” method of apportionment, the appellant offered to submit to apportionment by the “ objective ” method — *i.e.*, on the basis of the means of production applied in both parts of the business. As, for this company, labour is a factor of paramount importance, the appellant proposed to apportion the profit on the basis of salaries and wages paid, which would result in allocating 56.7 per cent to Netherlands East India.

52. The head inspector of taxes objected to the contentions of the appellant primarily because they considered only external factors, the business activities, and not the nucleus of the business — that is to say, its purpose of exploiting the possibility of profit in the country of sale. The head inspector further objected that the appellant assumed equal possibility of profit in all places where business activities took place. Furthermore, he contended that the system of apportionment in the ratio of salaries paid was wrong, because salaries and bonuses paid to directors were not paid only for labour, but also consist of a part of the profit of the enterprise. The directors’ salaries and bonuses should therefore be eliminated ; but even then it was doubtful whether salaries and bonuses paid to employees could properly be used as a basis for allocation, because of the great difference in the wage scale in different countries.

53. While admitting the importance of the acquisition of monopolies, the head inspector remarked that even such articles were subject to severe competition with similar articles which require an efficient selling organisation. Consequently, he contended that the business in Netherlands East India was of much more importance than the business in Holland and that 75 per cent of the total net profit should be allocated to the country of sale. In rendering its opinion, the Court of Tax Appeals observed that the appellant’s proposition was wrong in an economic sense, because it attached weight only to one external factor — *i.e.*, business activities, — and overlooked the function of capital. Therefore, the court questioned the fairness of apportioning in the ratio of salaries. Although admitting that these amounts might be helpful to a certain extent in allocating profits, the court was of the opinion that they could not be used as a basis, as quite other economic factors were also important. The court believed that a reasonable apportionment could only be effected by basing it on the proposition that the economic nucleus of the profit-making in an import business lies in the possibilities of selling. The court stated that it was practically impossible to calculate mathematically which part of the profit ought to be allocated to Netherlands East India, and therefore it would be necessary to reach an arbitrary conclusion approximating reality. In any event, the court could not adopt the objective system of the appellant.

54. The court considered that the changes in the conditions of the import business after the war pointed to the increased measure in which profit-making depended on the efficiency of selling, and consequently the steady decrease in the importance of buying. It considered that the circumstances of the seat and the book-keeping and supervision being in Holland were of minor importance in the economic process of profit-making. The court therefore concluded that, in the import business, the greater part of the profit-making must be allocated to Netherlands East India, and, in general, the ratio of 25 per cent to purchasing abroad and 75 per cent to selling in Netherlands East India, which had been accepted by several importers, was reasonable and approximated reality. Whether the goods sold were monopoly articles or not, the market could be kept only by

means of advertising, finding methods of competing with similar articles, watching the taste of buyers and changes in " fashion ", all of which must be done in the country of sale.

55. In another case,¹ however, the taxpayer, a foreign company purchasing and preparing tobacco in Netherlands East India, had valued its local profits at half of the total net profits. Seeing that the business of this taxpayer consisted in buying within Netherlands East Indian territory wet and half-dried tobacco, curing such tobacco, packing and exporting the finished product and selling it wholesale in Europe, the administration contended that even the entire profit might be considered as East-Indian profit. The Court of Tax Appeals, however, judged that, as the principal management for the buying, all the selling and the general financial management and the book-keeping were established in Europe, all of which were doing work of considerable influence in the making of profits, it would be a fair division to regard two-thirds of the net profit as East-Indian profit.

Spain and Switzerland.

56. The normal regime under Spanish law for taxing foreign companies carrying on business through an establishment in Spain is that of apportioning the total net income in accordance with a percentage or comparative ratio which is supposed to represent the importance of the Spanish establishment as compared with the enterprise as a whole.²

57. Although the method of fractional apportionment of total net income is generally employed by the various Swiss cantons, very few rules are found in their tax laws except in the legislation of Geneva, Basle-Urban and Zurich, and different rules exist for intercantonal and international business, which are completed by various principles laid down by the Federal Tribunal, in applying the provisions in the Federal Constitution, which prohibits intercantonal double taxation.³

UNITED STATES OF AMERICA.

Federal Law.

58. The precepts of allocating the whole income from purchase and sale to the place of sale, and of apportioning income as between manufacture and sale, have been incorporated in the United States Revenue Act, which contains furthermore a very complete system of allocation and apportionment to sources within and without the country. Somewhat similar provisions are contained in the laws of various American States, notably Wisconsin and Massachusetts.

59. Section 119 of the Federal Revenue Act of 1932 classifies gross income under three heads : (a) gross income from sources within the United States ; (b) gross income from sources without the United States ; and (c) income from sources partly within and partly without the United States.

60. The section also prescribes the deductions to be allocated to the items of income in each class in order to compute the net income of each class. The taxable income from sources within the United States includes that derived in full from sources within the United States and that part of the income which is derived partly from sources within and partly from sources without the United States which is allocated to or apportioned to sources within the United States.

¹ " Court of Tax Appeals Judgment of September 13th, 1926 ", No. 21, concerning the war tax on profits.

² *Infra*, paragraph 184 *et seq.* ; " Taxation of Foreign and National Enterprises ", Vol. I, page 143 *et seq.*

³ *Infra*, paragraphs 99 and 221 *et seq.* ; " Taxation of Foreign and National Enterprises ", Vol. II, pages 441 and 442.

61. The items of income, for which precise definitions of their sources in the United States are given, include interest, dividends, compensation for personal services, rents and royalties and gains from the sale of real property. This list is not exclusive, however, as other items of income derived from United States sources, which are included in the broad definition of "gross income" in Section 22 (a) of the Act. are to be also allocated to the United States. It is to be noted that all these items of income are susceptible of allocation to some definite physical source, such as interest to the residence of the obligor, dividends to the country in which the distributing corporation is organised, compensation for personal services to the country in which the services were rendered, rents and royalties to the country in which the property was situated, or the country in which the patent, copyright, secret process or formula, goodwill, trade mark, trade brand, franchise and other like property were used or in which the privilege of use was valid, and income from the sale of real property to the country in which the property was located.¹ In examining the accounts of the non-resident enterprise, the authorities have merely to segregate the various items indicated and include them in, or exclude them from, the assessment, in accordance with whether they are from the defined sources within or without the United States.

62. The balance of the income is covered under the general head "income from sources partly within and partly without the United States", and includes primarily income from the purchase of goods without and their sale within the United States, or *vice versa*, and income from the production or manufacture of goods without and their sale within the United States, or *vice versa*. All problems of allocation in regard to the first category of transactions are removed by the specific provision in Section 119 (e) which states that "gains, profits and income derived from the purchase of personal property within and its sale without the United States, or from the purchase of personal property without and its sale within the United States, shall be considered as derived entirely from sources within the country in which sold". It has been held that, for determining the place of sale in deciding the source of income, the substance of the sale is the agreement to sell, and consequently the income arises where the contract was concluded:²

63. If personal property is produced³ without and sold within the United States, or *vice versa*, the income is to be apportioned in accordance with interpretative provisions found in Article 682 of Regulations 77. This article provides, first of all, that the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or production department of the business to the distributing or selling department of the business at an independent factory price, provided such price has been fairly established by sales to wholly independent distributors or by other means unaffected by considerations of tax liability.

64. Where it is impossible to establish an independent factory or production price, the Regulations authorise fractional apportionment on the basis of property and gross sales. First, the net income is computed by deducting from the gross income derived from the production and sale of the personal property, the expenses, losses, or other deductions properly allocated thereto, and a rateable part of any deductions which cannot definitely be allocated to some item or class of gross income. Of the amount of net income so determined, half is apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country which is used in such production or manufacture, and the other half is apportioned in accordance with the

¹ See Regulations 77 of the United States Treasury Department. Articles 671 to 677; "Taxation of Foreign and National Enterprises", Vol. I, page 239 *et seq.*

² *Compañia General de Tabacos de Filipinas v. Collector*, 279 U.S. 306, 49 S. Ct. 304, 7 Am. Fed. Tax Rep. 8858.

³ "The word 'produced' includes created, fabricated, manufactured, extracted, processed, cured, or aged" (Article 682).

gross sales made by the tax payer within the United States and within the foreign country of the goods so produced or manufactured.¹

65. In any event, the taxpayer may apply for permission to base his return upon his books of account, if, in good faith and unaffected by considerations of tax liability, he regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the preceding methods the income derived from sources within the United States.

66. Except for a special formula prescribed for shipping companies² and another for determining the taxable income of foreign life insurance companies,³ the above-described system of allocation applies to all kinds of foreign enterprises operating in the United States and domestic enterprises operating both in the United States and in foreign countries. It may be mentioned that the special formulæ are, in practice, seldom employed, because most shipping enterprises are covered by arrangements for reciprocal exemptions with the countries to which they belong, and the number of foreign life insurance companies operating in the United States is very small.⁴

Wisconsin Statute.

67. The income-tax imposed by the State of Wisconsin also contains a complete system of allocation which is intended to prevent double taxation. Income is classified under various heads and certain items are allocated for taxation to the residence of the taxpayer, whereas others are taxable solely in accordance with the principle of origin. Thus, income derived from rents and royalties, from real estate or tangible personal property, or from the operation of a farm, mine or quarry, or from the sale of real property or tangible personal property, follow the *situs* of the property from which derived. All other income, including royalties from patents, income derived from personal services, professions and vocations, and from land contracts, mortgages, stocks, bonds and securities, or from the sale of similar intangible personal property, follow the residence of the recipient, except as provided in Section 71.095 regarding fiduciaries.⁵

68. By the same provision, income from mercantile or manufacturing business, not requiring apportionment under paragraph 71.02 (3) (d), follows the *situs* of the business from which derived.

69. The above-mentioned paragraph 71.02 (3) (d) deals with persons engaged in business within and without the State, and provides that they shall be taxed only on such income as is derived from business transacted and from property located within the State. The amount of such income apportionable to Wisconsin may be determined by an allocation and separate accounting thereof, when, in the judgment of the tax commission, that method will reasonably reflect the income properly assignable to Wisconsin. Otherwise, there is first deducted from the total net income of the taxpayer such items (less related expenses if any) as, in accordance with the above provision, follow either the residence⁶ of the recipient or the *situs* of the property. The remaining net income is apportioned to Wisconsin on the basis of the ratio obtained by taking the arithmetical average of the three following ratios :

(1) The ratio of tangible property, real, personal and mixed, owned and used by the taxpayer in Wisconsin in connection with his trade or business during the income year to the

¹ *Intra*, paragraph 267 *et seq.*

² Regulations 77, Article 683 ; *infra*, paragraph 534.

³ Revenue Act of 1932, Section 203 (c) ; *infra*, paragraph 506.

⁴ For a complete description of the above-mentioned provisions in the United States Revenue Act, see "Taxation of Foreign and National Enterprises", Vol. I, pages 238 to 246.

⁵ Wisconsin Statutes, 1927, Chapter 71 Paragraph 71.02 (3) (c).

⁶ A limit is imposed on the deductible amount of dividends and interest allocable to residence — namely, such amount is limited to the total interest and dividends received which are in excess of the total interest (less related expenses, if any) paid and allowable as a deduction under Section 71.03 during the income year.

total of such property of the taxpayer owned and used by him in connection with his trade or business everywhere ;

(2) In the case of persons engaged in manufacturing or in any form of collecting, assembling or processing goods or material within Wisconsin, the ratio of the total cost of manufacturing, collecting, assembling or processing within Wisconsin to the total cost of manufacturing or assembling or processing everywhere ;

(3) In the case of trading, mercantile or manufacturing concerns, the ratio of total sales made through or by offices, agencies or branches located in Wisconsin during the income year to the total net sales made everywhere during said income year.¹

70. If the taxpayer can show that the use of any one of the three ratios gives an unreasonable or inequitable final average ratio because of the fact that such person does not employ, to any appreciable extent, the factors made use of in obtaining such ratio, this ratio may, with the approval of the tax commission, be omitted in obtaining the final average ratio which is to be applied to the remaining net income.

71. In short, the Wisconsin system is first to allocate those items of total net income of the taxpayer which are definitely assignable to residence or to origin, and then either to allocate the balance of the income in accordance with the separate accounting of the taxpayer, if satisfactory, or to apportion such balance in accordance with a prescribed formula, or whatever variation thereof is necessary to assure an equitable division of profits.²

Massachusetts Statute.

72. Although the Massachusetts tax on corporations is an excise-tax and not an income-tax in the true sense, it is in part measured by the net income, determined for the purposes of the federal income-tax and adjusted in accordance with the Massachusetts law, which is apportionable under the Statute to Massachusetts. Thus, in the case of a foreign corporation having places of business both within and without the State, the following items of income are allocable in entirety to Massachusetts :

(a) Gains realised from the sale of capital assets,³ if such assets consist of real estate or tangible personal property situated in Massachusetts ;

(b) Interest received from any corporation organised in Massachusetts, or certain other debtors in Massachusetts.

73. On the contrary, the following classes of income of a foreign corporation shall not be allocated in any part to Massachusetts :

(a) Interest other than that described above as allocable in entirety to Massachusetts ;

¹ *Infra*, paragraph 274 *et seq.*

² For the complete provision in the Wisconsin Statute, see "Taxation of Foreign and National Enterprises", Vol. III, page 241 *et seq.*

³ The term "capital assets" does not include stock-in-trade sold in the ordinary course of business. For the purposes of allocation, expenses may not be deducted from income allocable in entirety. Such income is taxable, subject to the deduction in respect of machinery, to the extent that the corporation had income without deduction by reason of a federal net loss. The deduction for machinery is obtained by multiplying the total income allocable to Massachusetts by the ratio of the average fair cash value of machinery owned and used in manufacture in Massachusetts to the average value of the total assets employed in Massachusetts.

(b) Dividends ;

(c) Gains realised from the sale of capital assets other than those described above as allocable in entirety to Massachusetts.

74. After deducting the classes of income allocable in entirety, the remainder of the income is apportioned by means of a prescribed "allocating percentage" which is derived by taking one or the arithmetical average of two or all of the following three ratios :

(1) Average value of tangible property in Massachusetts to the average value of all tangible property of the enterprise ;

(2) Wages, salaries, etc., assignable to Massachusetts to the total wages, salaries, etc.

(3) Gross receipts assignable to Massachusetts to total gross receipts from the entire enterprise.¹

The taxpayer is permitted to propose an alternative basis for assessment such as income shown in the properly kept accounts of the local branch.

New York State Laws.

75. The New York State franchise-tax on business corporations, like the Massachusetts excise-tax, is not a pure income-tax, but is a tax on the privilege of exercising its franchise in New York in the case of a New York corporation, or for the privilege of doing business in New York in the case of a foreign corporation. Nevertheless it is measured by income. The tax is based upon the proportion of the entire net income of the corporation which the aggregate of certain assets within the State bears to the aggregate of such assets wherever located. These assets include: (1) the average monthly value of real property and tangible personal property ; (2) the average monthly value of bills and accounts receivable for specified transactions ; and (3) the average value of the stocks of other corporations owned by the taxpayer. The Commissioner of Taxes usually has recourse, however, to wide discretionary powers to adjust the tax as he considers most appropriate to the circumstances of the case.²

76. The New York personal income-tax on individuals, partnerships, estates and trusts is, on the contrary, a pure income-tax, and its regulations³ contain a very detailed system for allocating the business income of non-resident taxpayers, which reflects not only the influence of the federal system, but also the studies carried out under the auspices of eminent authorities on taxation. Income from business carried on wholly within the State is allocable thereto ; income from business carried on wholly without the State is excluded from assessment. Income from business carried on both within and without the State " must be apportioned so as to allocate to the State of New York a proportion of such income on a fair and equitable basis in accordance with approved methods of accounting ". This apportionment may be effected in one of three ways :

(1) In accordance with the books of the taxpayer, if the basis of apportionment used therein is approved by the Tax Commission ;

¹ *Intra*, paragraph 280 *et seq.* For complete description of the Massachusetts allocation fraction, see " Taxation of Foreign and National Enterprises ", Vol. III, page 241 *et seq.*

² Consolidated Laws of New York, as amended, Chapter 60, Article 9a, paragraph 214. See " Taxation of Foreign and National Enterprises ", Vol. III, pages 228 and 229.

³ Personal Income-Tax Regulations, corrected to July 1st, 1929, Articles 415, 445 to 457 and 470. See " Taxation of Foreign and National Enterprises ", Vol. III, page 218 *et seq.*

(2) If the books or the previously mentioned basis are not satisfactory, the total net income may be apportioned in the ratio which the aggregate of certain New York factors bears to the aggregate of the total factors as defined. These factors are :

- (a) Real property and tangible personal property ;
- (b) Payroll ;
- (c) Gross sales or charges for services performed ;

(3) The apportionment may be effected on an alternative basis submitted by the non-resident taxpayer, provided it is approved by the Tax Commission.

77. The pertinent articles of the Personal Income-Tax Regulations regarding allocation are quoted below :

“ *Article 455 : Business carried on wholly within the State.* — The entire net income of a non-resident from a business, trade, profession or occupation, carried on within the State (as ‘ business carried on ’ is defined in Article 415), and not carried on elsewhere, as so defined, is income from a source within the State of New York and taxable as such.

“ This is so, even though the non-resident or his representatives travel without the State for the purposes of the trade or business — that is, for the purpose of buying, selling, financing or performing any duties in connection with the business, and even though sales may be made to, or services performed for, or on behalf of, persons or corporations situated without the State.

“ *Article 456 : Business carried on wholly without the State.* — No part of the net income of a non-resident from a business, trade, profession or occupation carried on without the State of New York (as ‘ business carried on ’ is defined in Article 415), and not carried on as so defined within this State, is taxable.

“ This is so, even though the non-resident or his representatives may enter the State for the purpose of buying, selling, financing, or performing any other duty in connection with the business ; and even though sales may be made to, or services performed for, or on behalf of, persons or corporations situated within the State.

“ *Article 457 : Apportionment of Business Income from Business carried on both within and without the State.* — If a non-resident, or a partnership with a non-resident member, carries on business (as ‘ business carried on ’ is defined in Article 415) both within and without the State, the net business income therefrom must be apportioned so as to allocate to the State of New York a proportion of such income on a fair and equitable basis, in accordance with approved methods of accounting.

“ If the books of the taxpayer are so kept as regularly to disclose the proportion of his business income which is earned from sources within the State, the return of the taxpayer shall disclose the total income and the part apportioned to the State of New York and the basis upon which such apportionment is made. If such basis is approved by the Tax Commission, the return will be accepted.”

78. Here follow the provisions authorising the use of the allocation fraction which are quoted ¹ in the chapter on fractional apportionment in order to facilitate comparison with the provisions of other laws :

“ ‘ Business income ’, as used in Article 457, excludes profits (or losses) from the sale, exchange or other disposition of real property, and income from rents and royalties, income from these sources being taxable only if the property from which the income was derived was

¹ *Infra*, paragraph 285 *et seq.*

situated within the State of New York, and, in such case, the entire net income from these sources is taxable.

" *Article 470 : Alternative Basis of Apportionment.* — The provisions of Articles 451 to 470 dealing with the apportionment of income of non-residents earned from sources both within and without the State of New York are designed to allocate to the State of New York, on a fair and equitable basis, a proportion of such income earned from sources both within and without the State. Any non-resident may submit an alternative basis of apportionment with respect to his own income and explain that basis in full in his return. If approved by the Tax Commission, that method will be accepted instead and in place of the one herein prescribed."

The definition of carrying on business in Article 415 follows :

" A business, trade, profession or occupation (as distinguished from personal service as employee) is carried on within the State by a non-resident when he occupies, has, maintains or operates a desk room, an office, a shop, a store, a warehouse, a factory, an agency or other place where his affairs are systematically and regularly carried on notwithstanding the occasional consummation of isolated transactions without the State. This definition is not exclusive. Business is being carried on if it is here with a fair measure of permanency and continuity. A taxpayer may enter into transactions for profit and yet not be engaged in a trade or business. If a taxpayer pursues an undertaking constantly as one relying on his profit therefrom for his income or part thereof, he is carrying on a business or occupation. Thus a ' trader ' in securities who trades regularly and constantly on his own account and makes it his business to trade as another makes it his business to run a mercantile establishment is carrying on a business or occupation. Its regularity or continuity need not be for a long period ; the life of the business is not a material factor."

Other State Laws.

79. There are now in all more than twenty States in the American Union which levy taxes on net income. A State may tax the entire net income of domestic corporations and such portion of the entire net income of foreign corporations as is reasonably attributable to business done within the taxing State. Few States have availed themselves of the right to tax the entire net income of domestic corporations.¹

80. For the purpose of allocating the income of corporations to sources within the State, twelve States (besides Wisconsin)² allow separate accounting, provided the tax commission is satisfied it properly reflects income. Montana requires that income be determined in every case by that method, but, in view of the difficulties in maintaining separate accounts which accurately reflect income in some cases, the officials have given the law a reasonable interpretation³. A corporation doing business within and without the State is required to consider offices, storerooms, factories, mines and smelters in the State as a separate unit and report gross income from business transacted by that unit. From such gross income there are deducted such expenses and other allowable items as are definitely allocable to such unit, and that proportion of other allowable items, as gross income from Montana sources bears to total gross income.⁴

¹ These include Arkansas, North Carolina, Mississippi and South Carolina.

² Arkansas, California, Georgia, Massachusetts, Mississippi, Missouri, North Dakota, Oregon, Oklahoma, South Carolina, Utah and Virginia.

³ PRENTICE-HALL, " State Corporation Tax Service " (1930-31), Montana division, Section 1231.

⁴ Joseph Wallace HUSTON, " Allocation of Corporate Net Income for Purposes of Taxation " (1932), XXXVI, *Illinois Law Review*, 7, at page 745.

81. Oklahoma expects to make extensive use of separate accounting in connection with its recently adopted corporate income-tax. ¹ Idaho and Vermont have recently introduced corporate income-taxes and authorise the tax commissioner to prescribe regulations governing allocation.

82. The States which do not rely on separate accounting alone employ formulæ for the allocation of net income in the ratio of one or more factors, the formulæ of Massachusetts, New York and Wisconsin being fairly typical of the more complex type which predominates. Some States apply different fractions (simple or complex) to different types of business. The factor most frequently found in a simple formula is either tangible property or gross sales. Complex formulæ generally contain one or both of these factors and sometimes also cost of manufacture, and/or pay-roll. The factor of sales is frequently used alone in connection with mercantile corporations. The factors selected for manufacturing corporations often include tangible property, cost of production and pay-roll. The formula is usually composed of factors which will throw to the State the lion's share of the income. ²

83. It is obvious that, if a corporation manufactures in one State which apportions net income in the ratio of tangible property and sells in another State which uses the factor of sales, the corporation may be taxed on most of its income in both States — *i.e.*, on the basis of almost 200 per cent of its income. The use of other formulæ results in assessments which overlap to a burdensome degree. This double taxation is not illegal, but the Supreme Court has pronounced its disfavour and imposed certain limitations on the State taxing power. ³

United States Decisions.

84. The proposition that the income realised on the sale of goods may be split up into profits pertaining to the various stages in the acquisition or manufacture of goods which precedes sales was argued before the Supreme Court of the United States in the case of *Hans Rees' Sons Inc. v. State of North Carolina*. ⁴ The appellant was a corporation organised in New York, which was engaged in the business of tanning, manufacturing and selling belting and other heavy leathers. Its manufacturing plant was at Asheville, North Carolina. The wholesale part of the business consisted in selling certain portions of the hide to shoe manufacturers and others in car-load lots; and the retail part consisted in cutting the hide into innumerable pieces, finishing it in various ways and selling it in less than car-load lots. In order to facilitate sales, a warehouse was maintained in New York from which shipments were made from stock on hand to various customers. The tannery at Asheville was used as a manufacturing plant and a supply house, and when the quantity or quality of merchandise required by customers was not on hand at the New York warehouse, a requisition was sent to the plant at Asheville to ship to the New York warehouse or direct to the customer. The sales office was located in New York and the salesmen reported to that office. Sales were made throughout the United States, in Canada and continental Europe. Some sales were also made in North Carolina. Certain finishing work was done in New York.

85. The appellant stated that the profits from the wholesale business were in part attributable to the manufacturing in Asheville and in part to the selling in New York, but that the appellant's accountants made no attempt to separate this, and the entire wholesale profit was credited to manufacture and allocated to North Carolina. Similarly, it was said that no attempt was made to

¹ *Ibid*, page 745.

² For a detailed analysis of these fractions, see the above-mentioned article.

³ *Infra*, paragraphs 84 *et seq.*, 96.

⁴ 1931, 51 Sup. Ct. 385, 283 U.S. 123.

separate profits from manufacturing in New York from profits derived from manufacturing in Asheville, and that all manufacturing profits were allocated to North Carolina. It was insisted that the cutting of the leather into small pieces, finishing it in particular ways and supplying it in small lots to meet the various needs of individual customers were essential to the retail merchandise business conducted from the New York office.

86. The petitioner offered evidence to the effect that the income from the business was derived from three sources — viz. : (1) buying profit, (2) manufacturing profit, and (3) selling profit. It contended that buying profit resulted from unusual skill and efficiency in taking advantage of fluctuations of the hide market, and that none of these operations were conducted in North Carolina ; that manufacturing profit was based upon the difference between the cost of tanning done by contract and the actual cost thereof when done by the petitioner at its own plant in Asheville ; and that selling profit resulted from the method of cutting the leather into small parts so as to meet the needs of a given customer.

87. The assessment had been made on the corporation on the basis of a statutory allocation formula, which provides, *inter alia*, that a foreign corporation doing business within the State and deriving profits principally from the manufacture, purchase or sale of tangible property shall be taxed on such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in North Carolina on the closing date of the company's fiscal year is to the fair cash value of its entire real estate and tangible personal property then owned by it.¹ The taxpayer admitted that the allocation of its net income for purposes of taxation was in full accordance with the Statute, but contended that the assessment, upon the facts disclosed, was arbitrary and unreasonable, and was repugnant to the clause in the Federal Constitution forbidding the taxation of inter-State commerce and also to Section 1 of the Fourteenth Amendment, which forbids the taking of property without due process. Whereas the statutory method allocated to North Carolina approximately 80 per cent of the income of the appellant, it submitted an analysis showing that the percentage of its income attributable to North Carolina for the years in question did not in any event exceed 21.7 per cent.

88. In rendering the opinion of the court, Chief Justice Hughes reviewed the leading cases regarding the statutory formulae of certain other American States. In *Underwood Typewriter Company v. Chamberlain*,² the Connecticut Statute imposed upon foreign corporations doing business partly within and partly without the State an annual tax upon the net income earned during the preceding year on business carried on within the State, which was ascertained by taking such proportion of the whole net income assessable to the federal tax as the value of the corporation's real and tangible personal property within the State bore to the value of all its real and tangible personal property. The taxpayer manufactured products in Connecticut which, for the most part, were sold at branch offices in other States. The company contended that the tax was an unconstitutional burden upon inter-State commerce and that it violated the Fourteenth Amendment because of imposing a tax on business conducted without the State. It supported this objection by showing that, while 47 per cent of its real estate and tangible personal property was located in Connecticut, most of its net profits were received in other States. The court refused to sustain the objection, and observed that the profits of the corporation were earned by a series of transactions, beginning with manufacture in Connecticut and ending with sale in other States, and continued :

“ The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the

¹ Laws of 1923, Chapter 4, Section 201 ; 1925, Chapter 101, Section 201 ; 1927, Chapter 80, Section 311.

² 1920, 254 U.S. 113, 120, 121.

processes conducted within its borders. It therefore adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State."

As the taxpayer did not show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to the taxpayer produced an unreasonable result, the court upheld the validity of the Connecticut Statute.

89. The New York State Statute imposing an annual franchise tax upon the net income of a foreign corporation, as apportioned to the State in the ratio of the aggregate value of specified classes of assets of the corporation within the State to the aggregate value of such assets wherever located, was likewise upheld in the case of *Bass, Ratcliff & Gretton, Limited, v. State Tax Commissioner*.¹ A British company brewed and sold ale in England and exported a part of its products to the United States for sale in branch offices located in New York and Chicago. The question of the constitutional validity of the New York tax was considered by the court to be controlled in its essential aspect by the decision in *Underwood Typewriter Company v. Chamberlain (supra)*. The court said that it was not shown in the present case, any more than in the *Underwood* case, that the application of the statutory method of apportionment produced an unreasonable result. As the company carried on a unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with manufacturing in England and ending with sales in New York and other places — the process of manufacturing resulting in no profit until it ends in sales — the State was justified in attributing to New York a just proportion of the profit earned by the company from such unitary business. The court did not find "that the method of apportioning the net income on the basis of the ratio of the segregated assets located in New York and elsewhere was inherently arbitrary, or a mere effort to reach profits earned elsewhere under the guise of legitimate taxation".

90. The North Carolina State Court, having considered the preceding decisions, held that the Statute was valid, but concluded it was "not permissible to lop off certain elements of the business constituting a single unit in order to place the income beyond the tax jurisdiction of this State". The Supreme Court of the United States disagreed with this view. Chief Justice Hughes pointed out that evidence which was lacking in the *Underwood* and *Bass* cases was present in the *Hans Rees* case and added :

"These decisions are not authority for the conclusion that, where a corporation manufactures in one State and sells in another, the net profits of the entire transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either State. In the *Underwood* case, it was not decided that the entire net profits of the total business were to be allocated to Connecticut because that was the place of manufacture, or, in the *Bass* case, that the entire net profits were to be allocated to New York because that was the place where sales were made. In both cases, a method of apportionment was involved which, as was said in the *Underwood* case, 'for all that appears in this record, reached, and was meant to reach, only the profit earned within the State'. The difficulty with the evidence offered in the *Underwood* case was that it failed to establish that the amount of net income with which the corporation was charged in Connecticut under the method adopted was not reasonably attributable to the processes conducted within the borders of that State ; and, in the *Bass* case, the court found a similar defect in proof with respect to the transactions in New York."

91. The Chief Justice continued :

"Undoubtedly, the enterprise of a corporation which manufactures and sells its

¹ 1924, 266 U.S. 271, 280-283.

manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realisation of profits. The difficulty of making an exact apportionment is apparent, and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that, for the purpose of taxation, the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit', so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State. . . . When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."

92. Chief Justice Hughes concluded that the statutory method, as applied to the appellant's business for the years in question, operated unreasonably and arbitrarily in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that State, and consequently the taxes as laid were beyond the State's authority.¹

93. In the preceding case, the Supreme Court held it was not necessary for it to determine as a matter of fact the precise part of the income which should be regarded as attributable to the business conducted in North Carolina, this problem being left to the North Carolina State Court, to which the case was remanded for further proceedings consistent with the opinion of the Supreme Court.

SUMMARY OF LAW AND JURISPRUDENCE.

94. The preceding survey reveals how few Governments have considered allocation or apportionment in their fiscal legislation, and how few courts have ventured to establish criteria when called upon to interpret the general principles of the fiscal law of their country. Within the British Commonwealth of Nations, it seems to be well established, except in British India, that no profit is attributable to purchasing alone, and that the entire income arises at the place of sale. The separation of a merchandising profit from a manufacturing profit is recognised except in the Irish Free State, with regard to enterprises manufacturing in the country, and in British India. In the latter country, however, the all-embracing provisions of the law have been tempered by the courts in allowing the deduction of a commission on the sale abroad of goods manufactured or purchased in British India. In any event, the Privy Council has held that a production profit may accrue in one jurisdiction although the sale takes place in another. The principle of taxing income attributable to a permanent establishment in continental European countries implies an apportionment as between the local establishment and a foreign establishment, which together have produced income. The Netherlands East Indian jurisprudence evinces a scientific effort to separate selling profit from purchasing profit, and selling profit from manufacturing profit, in accordance with the relative importance of these activities from an economic viewpoint in the form of a percentage. Austria has crystallised the relative importance of such transactions by fixing ratios inserted in the treaties with Czechoslovakia and Hungary. Spain expresses in percentage form in every case the relative importance of the local establishment in the entire

¹ Subsequent to the decision in the Rees case, North Carolina amended its formula to include other factors than property, in the Revenue Act of 1931, Schedule D, Section 311. With regard to manufacturing corporations, the fraction includes, in addition to property, the factors: cost of materials, wages, and salaries, and overhead or manufacturing burden. With regard to mercantile corporations, the fraction includes property and sales.

enterprise. In carrying out the constitutional prohibition of double taxation, the Swiss Federal Tribunal has evolved a system of fractional apportionment of total net income in the ratio of productive factors. In the United States, the allocation of the entire income from purchase and sale to the place of sale and the separation of a production, processing or manufacturing profit from a sales profit are written into the Law and Regulations. The various allocation formulæ employed by the various States are intended to throw to their jurisdiction that part of the total net profit which is attributable to local activities, but the decisions upholding separate accounting and the decision in the Rees case indicate a tendency to determine the profit directly attributable to the activities of an establishment, rather than to apportion the whole net profit in the ratio of certain arbitrary factors.

COMPARISON OF AMERICAN AND SWISS LAW AND JURISPRUDENCE.

95. As commercial relations between countries become more and more closely knit, the situation becomes more nearly like that between States in the United States of America or between cantons in the Swiss Federation. Double taxation occurs between these States or cantons in the same manner as between one foreign country and another, owing to the difference in fiscal laws and the fact that the same persons are required to pay taxes on the same income or property by two or more fiscal jurisdictions. It is interesting to compare briefly the constitutional provisions and the jurisprudence which tend to prevent double taxation as between the North-American States or the Swiss cantons.

96. In the United States, appeals have been brought against various types of taxes, which resulted in double taxation, on the ground that they imposed a burden on inter-State commerce, which is contrary to the United States Constitution (Section VIII, paragraph 3), or that they deprived taxpayers of property without due process of law, which is prohibited by the Fourteenth Amendment thereto. These constitutional provisions likewise protect a foreign person doing business in the States. Although double taxation in itself is not illegal, the Supreme Court has regarded it with disfavour and restricted it more and more, notably in the field of inheritance taxes by imposing limitations on the fiscal powers of the State.¹

97. The Hans Rees case² makes it evident that the Supreme Court will not uphold an income assessment made by applying a State allocation fraction which a taxpayer proves to be arbitrary and unreasonable, but it has not enunciated any criteria as to what is a reasonable allocation. In two cases, corporations have relieved themselves from the application of an arbitrary formula on the grounds that the local business was conducted separately and therefore its income was properly reflected by its separate accounts.³

98. Various States endeavour to avoid double taxation, the California Statute expressly charging the administrator to use such methods as will prevent double taxation. But many of

¹ In the *Farmers' Loan and Trust Co. v. Minnesota*, 1929, 280 U.S. 204, the court said:

"Laws in respect of taxation should be construed and applied with a view of avoiding as far as possible any unjust consequences."

For cases which tend to prevent double taxation through imposing various limitations on the taxing power of the State, see *Frick v. Pennsylvania*, 1925, 268 U.S. 473; *Rhode Island Hospital Trust Co. v. Daughton*, 1926, 270 U.S. 65; *Safe Deposit and Trust Co. of Baltimore v. Virginia*, 1929, 280 U.S. 83; *Baldwin v. Missouri*, 1930, 281 U.S. 586, and the discussion of this point by Joseph Wallace HUSTON in "Allocation of Corporate Net Income for Purposes of Taxation", 1932, XXVI, *Illinois Law Review*, 7, at pages 745 to 748.

² *Supra*, paragraph 84 *et seq.*

³ *Standard Oil Co. v. Thoresen*, 1928, 29 F. (2d) 708; *Standard Oil Co. v. Wisconsin State Tax Commission*, 1929, 197 Wis. 630.

the States apply their formulæ without regard to the assessments made by other jurisdictions in which the corporation operates.

99. Within Switzerland, inter-cantonal double taxation does not present, however, as serious a problem as that between countries, one reason being that there is a great similarity in the tax laws of the different cantons. The cardinal reason is that the Federal Constitution, in Article 46, paragraph 2, not only prohibits double taxation as between the cantons, but grants taxpayers the right to appeal to the Federal Tribunal against any violation of that provision. Many inter-cantonal cases have been brought before this court, which has laid down various principles regarding allocation for the cantons to follow. Although not bound to do so, because the constitutional provision envisages only cantonal cases, the cantons often apply these principles in international cases. The basic principle enunciated by the Federal Tribunal is that, if an enterprise exploits establishments in different cantons, each of these may not tax the revenue of the local establishment itself, but only a part of the total net income. This part is determined by the ratio of the productive factors in the canton to the total productive factors of the enterprise, subject to a special allowance (*précipuit*) for the centre of management.¹

¹ *In/vra*, paragraph 221 *et seq.*; "Taxation of Foreign and National Enterprises", Vol. II, page 445

CHAPTER III.

ACCOUNTING REQUIREMENTS.

INTRODUCTION.

100. For the purposes of assessment, the taxpayer is generally required to submit a declaration of his taxable income. Furthermore, most countries require the submission of an annual balance-sheet and profit-and-loss statement. In the case of a foreign enterprise with a local branch, the authorities generally demand a balance-sheet and profit-and-loss statement pertaining to the branch and sometimes require as well similar accounts pertaining to the entire enterprise.

101. Such accounts are frequently inadequate when the local branch has carried on transactions with other branches of subsidiary companies of the same enterprise. The balance-sheet, showing the financial situation of the branch at the end of the year, and the profit-and-loss statement, reflecting its position during the course of the year, may be arithmetically correct, yet may not reflect a proper allocation of income as between the branch and the other units of the enterprise with which it has had dealings. In other words, tax authorities state they are forced to reject the accounts as made, because the prices at which goods have been transferred to or from the branch, or services have been rendered to or by the branch, are such that the latter's accounts do not reflect the income properly attributable to its activities.

102. Although the fiscal or commercial laws of the various countries may presuppose an accounting which reflects a proper allocation of income for tax purposes, they have not yet prescribed any definite criteria. Whatever requirements exist were for the most part formulated from the standpoint of national enterprises carrying on their business within the country or bringing home the profits which may have been earned abroad. Foreign enterprises which establish local branches are placed under the same general regime. The measures for relief from double taxation that have been instituted by laws or treaties presuppose an allocation as between the sources in the home country and abroad, but the burden has been on the taxpayer to show how much income should be excluded from the assessment to the home tax. This, of course, is a difficult question of fact, which has generally been settled by conference between the tax-collector and taxpayer, or by recourse to arbitrary or empirical computations.

103. An example of this burden of proof on the taxpayer is found in the Italian provision for exempting a national enterprise from tax on the profits earned by an autonomous establishment situated in a foreign country, provided it keeps proper separate accounts.¹ Another is in Section 131 (*e*)

¹ *Intra*, paragraph 569.

of the United States Act of 1932, which requires the taxpayer, when claiming credit against the United States tax in respect of taxes paid abroad on foreign income, to establish to the satisfaction of the Commissioner of Internal Revenue, not only (1) the total amount of income derived from sources without the United States, determined in accordance with Section 119, which embodies a detailed system of allocation, but also (2) the amount of income derived from each country in respect of the tax of which credit is claimed, and (3) all other information necessary for the verification and computation of such credits. This section authorises the Commissioner to prescribe rules for carrying out the requirement under (2) above.

104. The import of provisions such as these is clear. Unless the taxpayer, in conducting relations with its foreign branch, transfers goods or makes charges at prices which can be proved to be fair, it may not only have difficulties in satisfying the tax authorities in the countries where the branch is situated, but also in supporting its claim for credit against the American tax. If the taxpayer shifts profits to the foreign branch through artificial or unfair pricing, the foreign authorities may gladly accept payment of tax on the amount of profit which is larger than that properly assessable; but the United States authorities may refuse to grant a credit for such foreign tax, and the taxpayer must suffer double taxation in respect of the amount involved.

105. So many taxpayers have kept accounts in such a manner as to conceal profits that numerous officials declare they always view branch accounts with suspicion, because they can be made to show whatever is most convenient to the taxpayer. An accounting which reflects a fair allocation of income is, however, the prime essential in preventing double taxation through the overlapping of assessments. Such accounts are kept by a number of concerns, and can be kept by almost every enterprise. Guiding principles of allocation accountancy and methods of fixing transfer prices which should result in a fair allocation of income are subsequently described.¹

106. The foundations for allocation accountancy are found in existing methods, and it is therefore opportune to describe in general terms the present requirements. In no country does the fiscal law prescribe any particular method of accounting, although some laws specify in detail allowable deductions and methods of evaluating assets, or fixing allowances for depreciation. Prescribing detailed rules of accounting is generally considered to be unwise, because of the great differences that exist in the method of operation of enterprises. Furthermore, the keeping of accounts is required by the commercial law in countries in continental Europe and those in South America and the Orient, which follow the European system as models. In Anglo-Saxon countries, accounting is not only the general practice, but it has been developed into a fine art by the British chartered accountants and the American certified public accountants.

CONTINENTAL EUROPE.

107. In most continental European countries, the Commercial Code requires that every enterprise, whether national or foreign, carrying on business within its territory should keep the books of accounts which are necessary to reveal its exact financial situation. The requirements of the German Commercial Code may be given as an example. Every person engaged in commerce must, upon starting business, make an exact statement of his immovable property, of all accounts receivable and accounts payable, of his cash in hand, and of all the property belonging to him, the value of each piece of property being separately mentioned. He must draw up a balance-sheet

¹ *Infra*, Chapter XII.

showing the relation of his assets and liabilities. At the close of every business year, which may not exceed twelve months in duration, he must draw up a similar balance-sheet. In the inventory and balance-sheet, each item of the assets and liabilities must be set down at the value which ought to be ascribed to it at the date in respect of which the inventory and balance-sheet are drawn up. Books of account, business letters, inventory and balance-sheets ought to be retained for a period of ten years. ¹

108. In Spain, the books required are as follows: the balance-sheet and accounts book, journal, ledger, a book containing copies of letters and telegrams and any other books which may be required by special laws.

109. The law of practically every country, except the United Kingdom, requires that the taxpayer permit the authorities to examine his books of account. In general, they afford the basis of assessment to tax and are only disregarded if they are insufficient. In this respect, the law of Roumania is interesting, as the Income-Tax Commission is required to take the books of account as the basis of assessment, provided they are regularly kept. Instances in which the Roumanian courts have upheld the disregarding of the books include the following:

- (a) Failure to enter the date of invoices;
- (b) The books and balance-sheet contained fictive entries;
- (c) The balance-sheet and profit-and-loss statement of a company were not approved by the general meeting of shareholders;
- (d) The succession of entries in the journal did not correspond with those in other books;
- (e) Transactions were entered in the books in a summary manner and were not supported by the necessary documents;
- (f) Entries were not made daily. ²

110. As the commercial codes applicable in the different parts of Poland have not yet been unified, the requirements as to the books that must be kept vary, although they are essentially the same as those described above. Special provisions have been indicated in regard to drawing up the balance-sheets of corporations in the Company Law of March 22nd, 1928. There are also special requirements concerning banks in the Law of March 17th, 1928.

NETHERLANDS EAST INDIA.

III. Although the fiscal law of Netherlands East India contains no requirements as to book-keeping, the Company Tax Ordinance (Article 13) requires that foreign corporations operating in that country must arrange their book-keeping in such a way as to show everything necessary for the calculation of the profit made by the business in Netherlands East India. The taxpayers have been expressly informed that, in the verification of the declaration made by the company, this book-keeping will be taken as a starting-point. Companies incorporated in Netherlands East India must record their dealings in such a way as to show the profit made through the enterprise, or from capital employed outside the enterprise. Companies incorporated abroad must keep their books in such a manner as to show, not only the profit made through the business in Netherlands East India, but also income from reserve funds belonging to that business, regardless of where they may be

¹ *Handelsgesstbuch*, paragraphs 4, 6, 38 and 40.

² "Taxation of Foreign and National Enterprises", Vol. II, page 399.

invested. The books must be kept in either Dutch, Malay or Chinese, or in another language approved by the Director of Finance (French, English, German). The book-keeping must include a continuous record of the cash position, statement of debtors, creditors and stocks, which must be kept up regularly and closed off annually, and, furthermore, a balance-sheet must be made up every year. The books and documents relating thereto must be kept for ten years.

MEXICO.

112. The Mexican tax law requires that the books of account specified by the Commercial Code (day-book, ledger, book of inventories and balances, and book of company acts) be legalised by the tax-collector's office in the district in which the taxpayer is situated. It also contains a number of detailed provisions, notably in regard to the cost at which goods are to be entered in the inventory, and to allowable deductions.¹

113. To facilitate assessing foreign enterprises on profits from sales in Mexico, it is required that travelling salesmen, commission agents or employees of companies domiciled abroad must declare the total amount of sales made through them. For this purpose, they must keep a special book of orders in which they enter chronologically the transactions effected through them, specifying the merchandise sold, the sale price, the name and domicile of the purchaser and the number of the invoice, if any. They must also keep their correspondence in accordance with the requirements of the Commercial Code.²

BRITISH COMMONWEALTH OF NATIONS.

114. In the United Kingdom and other countries of the British Commonwealth of Nations, no particular form of account is prescribed by the Income-Tax Acts, and, if the true profits cannot be readily calculated from the accounts submitted, the Inspector of Taxes would institute further enquiries with a view to reaching an agreement with the taxpayer as to the amount of the profits. The British India Income-Tax Act (Sections 8 to 13) requires that the income from a business or profession shall be computed in accordance with the method of accounting regularly employed by the assessee; provided that, if no method of accounting has been regularly employed, or if the methods employed is such that the income, profits and gains cannot be properly determined therefrom then the computation shall be made on such basis and in such manner as the income-tax officer may determine. The onus to prove his income is always on the taxpayer.

UNITED STATES OF AMERICA.

115. Precise requirements in regard to accounting are found in the United States Revenue Act of 1932 and Regulations 77. The net income of any taxpayer is computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be), in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. If no method of accounting has been regularly employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as, in the opinion of the Commission of Internal Revenue, does clearly reflect the income.³

¹ "Taxation of Foreign and National Enterprises", Vol. III, pages 119 to 121, paragraphs 64 to 74.

² Regulations, Article 40 *bis*. See *ibid.*, paragraph 87.

³ Revenue Act of 1932, Section 41.

116. Certain essentials of accounting are prescribed¹ as follows :

“ (1) In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see Section 22 (c) and Articles 101 to 108);

“ (2) Expenditures made during the year should be properly classified as between capital and expense — that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account ; and

“ (3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expense.”

117. In the United States, the accounting of a taxpayer may be either on a cash or accrual basis, provided in either case that it clearly reflects the income. Accounting on a cash basis means that the net income must be determined by including all the gross income actually received, and deducting only the amounts actually paid out.² Where the cash basis is used, income constructively received must also be included.³ An accounting system is said to be on an “ accrual basis ” if income is taken into consideration when earned, even though not paid in cash, and expenses are considered as soon as incurred, whether paid or not.⁴ A system of accounting which combines the cash and accrual bases is inconsistent and not generally allowed for federal tax purposes, but it is admitted that no system of accounting will be entirely on an accrual basis.⁵

118. All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer and deductions taken accordingly, unless, in order clearly to reflect income, such amounts are to be properly accounted for as of a different period. For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. Appreciation in value of property, however, is not even an accrual of income to a taxpayer prior to the realisation of such appreciation through sale or conversion of the property.⁶

¹ Regulations 77, Article 323.

² Appeal of Consolidated Asphalt Company, 1 B. T. A. 79.

³ Regulations 77, Article 332.

⁴ Clarence Schock, 1 B. T. A. 528 ; Appeal of Owen-Ames-Kimball Company, 5 B. T. A. 921.

⁵ Niles Bement Pond Company v. United States, 67 Ct. Cl. 693, 7 Am. Fed. Tax Rep. 9128.

⁶ “ Taxation of Foreign and National Enterprises ”, Vol. I, pages 247 and 248.

CHAPTER IV.

FOREIGN ENTERPRISES — GENERAL METHODS OF ALLOCATION.

INTRODUCTION.

119. Inasmuch as in most countries there is little legislation or jurisprudence concerning the allocation of income, it is necessary to study carefully the practices followed by the various administrations in allocating income to national or foreign sources. In general, the tax on industrial or commercial enterprises is based on the net income of the accounting year (fiscal or calendar year) of the enterprise ending within the taxable year, the closing date of which differs in many countries. The computation of the net income of a local establishment of a foreign enterprise entails the allocation of items of gross income and also the cost of producing such income, even though incurred in another country. It is in respect of the apportionment of deductible expenses and losses — for example, items such as interest on general indebtedness or general overhead expenses — that some of the most difficult problems are encountered.

SUMMARY OF METHODS.

120. The methods of allocation or apportionment which are employed in the various countries may be broadly classified as : (1) method of separate accounting ; (2) empirical methods ; and (3) method of fractional apportionment. The method of separate accounting means taking the declaration of income, supported by the accounts of the local branch, as a basis of assessment. This may entail a verification of the accounts and enquiry into the relations between the local branch and other establishments (branches or subsidiaries) of the parent enterprise, which involve, for example, consideration of the price at which goods have been invoiced to the branch and their original cost, and the amounts charged to the branch for services or representing a portion of general overhead expenses. ¹

121. Empirical methods are frequently employed by tax administrators when they have reason to believe that the declaration of income based on the accounts of the enterprise is insufficient or false. The authorities attempt to estimate an income by comparing the given enterprise with similar enterprises, or taking into account turnover, assets and other readily ascertainable factors. ²

122. Although the method of fractional apportionment might properly be considered an empirical method, it is treated under a separate head, because of its being the primary method

¹ *Intra*, paragraph 128 *et seq.*

² *Intra*, paragraph 155 *et seq.*

of certain countries, including Spain and Switzerland, in allocating taxable profits to the local establishment, and France, in connection with the tax on income from securities. By fractional apportionment is meant the determination of the income of one establishment of an enterprise by dividing total net income in the ratio of certain factors — for example, assets, turnover, pay-roll, or a fixed percentage. The practice varies, some countries apportioning merely the joint income which the local establishment and an establishment abroad have together produced (*e.g.*, one manufacturing and the other selling), whereas other countries apply the apportionment fraction to the entire net income of the enterprise.¹

123. No country follows exclusively one method or the other. The examination of the declaration and local accounts is generally the starting-point. If satisfied that the profit is reasonable, the authorities (except the Spanish) usually stop there. The tendency is growing, however, to look more closely into the company's own method of allocating or apportioning income as between its various branches or subsidiaries. This involves scrutinising the transactions between the local branches and the other branches or subsidiaries, and sometimes a detailed examination of the balance-sheet, profit-and-loss statement, and other accounts and correspondence kept at the head office, and possibly of the basis for apportionment of certain items of gross income or general expense as between the head office and the branch. The agreement between the Netherlands and Netherlands East India, whereby trained accountants of the latter administration are stationed in Amsterdam to examine the head-office accounts of Dutch companies operating in East India, was made for this very purpose.

124. Obviously, if the head office is in a foreign country with a different language and currency, or where it is not the practice to have accounts audited by certified or chartered experts, the authorities will generally prefer to rely on information locally available in verifying accounts and in making, if necessary, an empirical assessment.

125. The practices in the various countries depend on so many factors that it is difficult to synthesise them. Among the more important factors are the general level of "tax integrity" of enterprises within the countries involved, the development in accounting science, the standing of the accounting profession, the training of the tax officials, the historical background of methods of assessment, the very character and intelligence of the people of the country. In countries of the British Commonwealth of Nations and in the United States, where, as a general rule, accounts are regularly audited and certified by reputable public accountants, the officials, who are equally well trained, try to arrive at an assessment on the basis of the separate accounting of the local enterprise, and they will make necessary adjustments in prices or amounts entered as gross income or deductions, rather than resort to an empirical or fractional assessment. Their principal difficulties are encountered in verifying whether the invoice price to a local sales branch effects a fair apportionment of profit as between it and the factory abroad, and in checking the apportionment of general overhead and interest on general indebtedness.

126. The fact that tax integrity is highest in countries where the level of accounting practice is highest is not a mere coincidence. The movements in several European countries to elevate the accounting profession to one of dignity and trust show that this is well understood. This development is perhaps handicapped by the historic practice in countries where the income-tax has succeeded rather recently to the *patente* tax on business enterprises, or a tax of similar nature. Such levies were computed on an empirical or *forfaitaire* basis, taking into account such readily ascertainable elements as outlay for rent or salaries, or other "outward and visible signs". It

¹ *Infra*, paragraph 173 *et seq.*

is only natural that officials accustomed to these methods should turn to them when the accounts adduced for tax purposes are insufficient.

127. The failure of foreign enterprises in general to keep fair accounts and the inability of the administration to check original costs are given as the reasons why Spain completely abandoned separate accounting as a method of assessment and required that in every case the local branch be taxed by a fractional apportionment of the total net income of the enterprise in the ratio of the relative importance of the local branch. As will be shown, other administrations resort to fractional apportionment as a method of assessment in lieu of an adequate separate accounting, and some as a primary method. There is no clear-cut dividing-line between recourse to one method or another, but the general practices in most of the countries with income-taxes are briefly described in the following paragraphs.

METHOD OF SEPARATE ACCOUNTING.

128. It is significant that separate accounting should be the method normally followed in the country which has the largest experience in the taxation of income and, at the same time, has accountants of the highest professional standing. What is true of the United Kingdom is likewise true of other countries of the British Commonwealth of Nations and also of the United States of America. The United Kingdom income-tax and practices have been followed to a large extent in the other countries mentioned, and the standards of accounting have been carried abroad because of the fact that the leading accounting firms in the United Kingdom have followed their clients to all parts of the world to audit their branch accounts. Similarly, the branches in the United States of these same accounting firms and similar American firms have developed accounting practices to keep abreast with the complex structure of business organisations and methods in that country, and they in turn have followed their clients abroad.

129. The use of separate accounting as the primary method coincides fairly closely with the field of operation of these reputable firms. But, even in this field, difficult questions of allocation or apportionment arise, because of conflicting viewpoints as to what is a fair transfer price, charge or evaluation. Such questions, however, are as a rule obviously within the province of the export manager or other officers of the company rather than in that of the accountant who has to deal with the prices or values which may have been fixed after consideration of factors not subject to his control.

British Commonwealth of Nations.

130. The British inspector of taxes examines the declaration of the taxpayer and the supporting statements. If the profit of a sales branch appears to be unreasonably low, he may endeavour to ascertain the figure at which similar goods are sold by the foreign enterprise to an independent dealer in the United Kingdom under conditions that are customary in the particular trade, and, in other cases, to determine an independent market quotation for similar goods. If the enterprise markets its own goods and therefore makes no sales to independent dealers, or if the goods are of a special kind which have no independent market value, the British inspector resorts to other lines of negotiation. He may attempt to ascertain the actual or approximate cost of the goods sold in the United Kingdom. Once their sale price is known, he may be able to establish an intermediate price for invoicing the goods to the branch in the United Kingdom, making due allowance for a manufacturing profit which is allocable to the foreign country. The United Kingdom authorities have no definite precepts for fixing the relative importance of manufacturing and merchanting profits, as they consider that the relative percentages depend on the particular business and processes, but in some instances they base their decision upon a

comparison with similar enterprises in which the relative importance is clear. As a general rule, when the British authorities and the taxpayer disagree, the authorities make an attempt to "hammer out a compromise", and this is frequently successful. The taxpayer generally prefers to come to an agreement rather than be assessed on a percentage of his turnover. If no agreement is reached, the tax authorities may estimate a profit, and the taxpayer would have the burden of proof that the assessment was excessive.

131. Similarly in the other parts of the British Empire, the general practice is for the local establishment to keep separate accounts which will serve as a basis for taxing the income from its commercial operations. Thus the Irish Free State administration reports that there is no difficulty in applying this method when the establishment therein obtains raw material from an independent source and does a separate manufacturing business. In the case of interlocking transactions, however, the authorities encounter the same difficulties as those described above, and the administration stresses the importance of obtaining a clear idea of the intra-company transactions, such as examining the current account between the foreign enterprise and the local establishment or other internal accounting arrangements. The Irish Free State employs the same methods for checking and correcting invoice prices as those used in the United Kingdom.

132. The Canadian practice is very flexible. The authorities first examine the books of the local branch of a foreign enterprise in order to check the accuracy of its declaration. When the fairness of the invoice price of imported articles is doubted, the authorities often request information concerning the cost of manufacture, and, if necessary, they endeavour to arrive at a fair price by discussions with the taxpayer. If this procedure proves to be futile, they may have recourse to apportionment.

133. The acceptance of separate accounting by the British India authorities depends upon their reflecting the allocation of profits required in the Act. That is to say, the accounts of the local branch should show the entire net profit derived from the sale in India of goods purchased or manufactured abroad, and the branch may be required to produce, in corroboration of the entries in its accounts, a certificate from the auditors or a competent official of the parent company that the prices charged to the branch (or subsidiary company) are true costs of purchase or production and do not include any element of profit. Rates of interest which are unduly high or unduly low attract attention, and the income-tax officer may use his discretion as to the evidence required to justify management charges, patent royalties and the like.

134. Likewise, the South African authorities will tax on the basis of satisfactory separate accounts. The invoice price of goods shipped to the branch as declared for Customs purposes is generally accepted, because the fact that the duties are levied on the gross value of the goods is sufficient protection against inflating the invoice price. Charges for interest and payments for services rendered or for the use of patent rights or secret formulæ are not allowed in branch accounts unless it is proved that they represent an allocation to the branch of charges borne by the enterprise as a whole.¹ In that case, they would be allowed if the Commissioner was satisfied that the allocation was fair and reasonable, having regard to the relative activities of the branch and the rest of the enterprise. On the other hand, such charges, if genuine, would be allowed if made to a subsidiary company.

United States of America.

135. The United States authorities attempt, as a general practice, to determine the income of

¹ 3 S. A. Tax Cases 328 ; Income-Tax Case No. 103.

a local branch of a foreign enterprise on the basis of its separate accounts. In the case of foreign manufacturing and mercantile enterprises, the sales profit realised in the United States is fixed by ascertaining the "independent factory price" at which the foreign manufacturing plant would sell to an independent dealer. The net amount realised in the United States over this factory price is taxable therein, whereas the manufacturing profit is allocated to the foreign country. This sometimes necessitates adjustment in the invoice price at which goods have been transferred to the local branch. Sometimes the tax officials make an analysis of the world business of the foreign enterprise in order to bring out facts relating to operations within the United States which will permit an adjustment of accounts on a reasonable basis.

France, Belgium and Luxemburg.

136. In France, the object of the tax on industrial and commercial profits is the profit earned through the activities of a permanent establishment situated in France, whether the enterprise is national or foreign, and those profits should be contained in the declaration and in the supporting accounts. The same principle applies with regard to foreign enterprises operating in Belgium, and the separate accounting of the local branch must reflect all the operations realised in the country by or through the branch, whether the relations are with persons residing in the country or abroad, and whether the operations are initiated by the local establishment or simply completed through it. The law requires that the branch must be credited with transactions which it makes or for which it serves as intermediary. For example, the accounts must contain the interest received in Belgium, as well as the income derived from investing funds in Belgium by the branch in accordance with orders emanating from the head office abroad. On the other hand, the deductible items include the general overhead or costs of administration of the Belgian establishments and the various expenditures made by those establishments. They do not include the interest or premiums paid by the local establishment to bondholders of the company, nor directors' percentages taken from profits realised in the country; an exception to this rule would only be admitted if the appropriate Belgian schedular tax were levied on those items. Luxemburg generally taxes on the basis of the declaration and accounts of the foreign enterprise, unless it is necessary to resort to an empirical or fractional assessment.

Italy.

137. The principle of determining separately the income of the local branch is well established in Italian fiscal law. The declaration pertaining to the income of the local branch is verified by reference to a balance-sheet which must be published by virtue of Article 230 of the Italian Commercial Code, and the authorities may avail themselves of any means to prove its accuracy, including a comparison with similar enterprises, if any exist. The authorities may even demand submission of the general accounts of the foreign company for the purpose of constructing a balance-sheet for the local branch according to the principles of fiscal law.

Germany.

138. In Germany, the accounts of all enterprises are frequently subjected to a thorough examination by the tax authorities and a movement is under way to create a body of accountants authorised to audit the accounts of companies for tax purposes. The general practice is to determine the income of local branches of foreign companies separately when a separate and proper system of book-keeping exists and when a separate and reliable computation of the German income is possible, subject to the local accounts being adjusted to conform with the special provisions of the tax laws.

Central Europe.

139. The situation in Austria, Czechoslovakia and Hungary is of especial interest because, although the initial step generally followed in taxing foreign enterprises is to verify their declaration

comparison with similar enterprises in which the relative importance is clear. As a general rule, when the British authorities and the taxpayer disagree, the authorities make an attempt to "hammer out a compromise", and this is frequently successful. The taxpayer generally prefers to come to an agreement rather than be assessed on a percentage of his turnover. If no agreement is reached, the tax authorities may estimate a profit, and the taxpayer would have the burden of proof that the assessment was excessive.

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Central Europe.

139. The situation in Austria, Czechoslovakia and Hungary is of especial interest because, although the initial step generally followed in taxing foreign enterprises is to verify their declaration

by reference to the separate accounts of the local establishment, these three countries have entered into agreements prescribing an apportionment of the profit derived from the co-operation of establishments in each of the two contracting countries. The Austrian Commercial Code requires the keeping of books pertaining to the local establishment, but the administration declares it is not possible in most cases to rest content with the particulars of the separate balance-sheet, as the results shown therein are often distorted because of transactions with establishments in other countries. This is especially true where goods are invoiced at more or less arbitrary prices by a foreign factory to a local sales branch, or *vice versa*. The administration is not bound to artificial invoice prices and may therefore resort to any available method of estimating a profit in accordance with the real facts. The general practice is to check delivery prices by comparison with the prices paid or asked by Austrian enterprises of the same kind, or by comparison with official price-lists or by enquiries on the part of experts. Price corrections of this kind are, however, not the only way of departing from the separate accounts submitted by the enterprise. Other receipts may be wrongly shown in the accounts in favour of the foreign centre of management of the enterprise, and may represent the transfer of business results which ought really to be ascribed to the Austrian establishment. Such transfer may occur in the following cases: the attribution in the accounts of interest resulting from a more or less artificial allocation of the capital allotted to the establishment by the centre of management, the attribution of compensation for the services of foreign directors, and the attribution of royalties for the sale of patents and similar rights exploited in manufacturing operations. The Austrian authorities regard these artificial allocations to the centre of management as a part of the profits earned in Austria, and consequently write them back into the Austrian accounts for tax purposes.

140. In order to facilitate the apportionment of profits when goods have been purchased in one country and sold in another, or manufactured in one country and sold in another, Austria has entered into the above-mentioned agreements with Czechoslovakia and Hungary, which provide for an apportionment in accordance with fixed percentages, applicable to the income resulting from such transactions.¹

Northern, Eastern and South-Eastern Europe.

141. Taxation on the basis of the separate accounts of the local establishment, subject to verification, is the initial procedure in the Northern European States, including Denmark and Sweden, and the Eastern European States, including Danzig, Estonia, Latvia and Poland. The same is true in the Balkan countries, including Bulgaria, Yugoslavia and Roumania. In Greece, the question of allocation is obviated to a large extent because of the fact that Greek corporations are taxable only on profits distributed as dividends, and foreign corporations with branches in Greece may elect to be taxed on the basis of their distributed profits. This provision is intended to favour foreign companies which operate primarily in Greece. Nevertheless, as a general rule, the method of separate accounting is considered preferable by the administration. Even if a foreign enterprise which has a branch in Greece does not keep complete accounts, the administration tries to determine the profits of the branch according to the principles of separate accounting, provided it has available sufficient data to determine the profits. In checking the invoice price of articles sent by the foreign enterprise to a local establishment, the administration may look into the general manner in which the foreign enterprise usually conducts its business, and may seek to ascertain the true cost of manufacture of the foreign products. To this price, a reasonable percentage may be added to represent the profit of the manufacturing establishment and, in this way, the invoice price will be approximately that quoted in the foreign market. To this figure, the cost of transport, insurance, etc., will be added. In principle, the administration will be satisfied with the accounts of a foreign enterprise, but, if it is not satisfied, it may require other data or

¹ *Infra*, paragraph 249 *et seq.*

certificates — for example, with regard to quoted prices or to the sales price to independent purchasers. If still dissatisfied with the information obtained, the Greek administration may resort to making a comparison with national enterprises of the same character, if there are any, and the price at which these enterprises purchase from a foreign manufacturer is considered as the invoice price for the taxpayer. In default of such material, the authorities may resort to an empirical assessment, or to an assessment on the basis of an agreement with the taxpayer.

Netherlands and Netherlands East India.

142. The situation in the Netherlands and Netherlands East India is of especial interest because of the arrangements between the two countries for the examination of the accounts of companies with their head office in one and carrying on business in the other. As the Netherlands imposes its income-tax only on distributed profits, most foreign corporations desiring to operate in that country have organised companies in conformity with its laws. As regards foreign companies operating in the Netherlands through branches, the authorities verify the declaration of profits made within the country by consulting the accounts, subject, of course, to whatever corrections may be necessary. The Netherlands report stresses the fact that, even if the separate accounts of the local branch are taken as a basis, it is impossible to avoid resorting to rough estimates or arbitrary determinations of items of gross income or allowable deductions. If a local sales branch has separate accounting, the normal invoice prices are ordinarily taken as a basis for calculating the profit. Sometimes the administration resorts to a comparison with normal invoice prices made in respect of the sale of similar articles between independent parties, and also examines the value declared for Customs purposes. Patent or copyright royalties which are not included in the invoice price are not deductible from gross profits allocable to the Netherlands, and the same rule applies in the case of royalties paid for the use of patents by the branch. On the other hand, an equitable deduction is allowed for accounting and administrative services rendered by the centre of management abroad to the Netherlands branch. Deduction of interest on capital invested in the enterprise is not permitted.

143. The tax in Netherlands East India is payable by foreign enterprises in respect of the profits derived from carrying on an enterprise—that is to say, a business or industry—in the country. Because of its being a country poor in capital but rich in natural products which are exploited by foreign enterprises, the tax administration of that country has evolved theories of allocation which are intended to preclude, as much as possible, an exhaustion of its wealth. According to an official explanation of the aforementioned principle, liability arises if the foreign enterprise has economic relations with Netherlands East India, and is delimited by the extent of these economic relations. Tax liability is not restricted to profits from business activities taking place within the boundaries of Netherlands East India, and the business unit situated therein is taxable on all activities emanating from it, even if some of the activities take place outside that country. This latter interpretation is subject to the exception, however, that, if the business unit (of the foreign enterprise) in Netherlands East India has permanent establishments in other countries to which its activities extend, then the profits attributable to such establishments are not taxable in Netherlands East India.

144. A corollary of the above principle is that all income derived from capital set aside by the foreign enterprise for carrying on economic relations with Netherlands East India is taxable. Consequently, income is allocable to Netherlands East India for tax purposes whether it is in the form of income derived from using the capital in the business in that country or placing the capital temporarily unemployed for such purposes in a bank in Netherlands East India or abroad. The reason for this attitude of the administration is that the amount of money needed in carrying on business in Netherlands East India fluctuates from time to time, especially in the case of agricultural

enterprises, and the funds temporarily unemployed or waiting to be used in the business cannot obviously be separated from the business itself. Consequently, when directors have set aside a part of the profits as a reserve, these funds really belong to, and fulfil a function in, the business in Netherlands East India even though they are deposited in a bank abroad or invested in foreign securities. The administration contends that, if the funds are placed on deposit, there is no essential difference whether the funds are deposited by the branch of the enterprise in the Netherlands East Indian branch of a bank or by the head office of the enterprise in the principal establishment of the bank abroad. The administration also argues that it is immaterial whether the bonds or stocks purchased are kept by the head office or the branch, and whether the income is received abroad or in Netherlands East India. The administration even extends its theory to the taxation of income from securities used as collateral on loans to be employed in the business in Netherlands East India, as such income is considered to be a part of the earnings of the business in that country. The cardinal test employed is whether the funds belong to, or are destined for use in, the business in Netherlands East India, regardless of what they are called. Such funds include, *inter alia*, funds to pay cost of leave to employees, depreciation, reserve or repair funds, pension reserves, reserves for taxes or other purposes. If the funds lose their character as a reserve for business in Netherlands East India, the income therefrom ceases to be taxable. Such is the case when the reserves have grown so large that they are more than adequate for the possible needs of the business in Netherlands East India and the directors give this excess the character of a permanent investment outside the local business. For example, such an investment is constituted when the money is invested in another business in Netherlands East India or abroad, through founding a subsidiary company or buying the shares of an existing company.

145. It is natural that the greater number of foreign enterprises operating in Netherlands East India are Dutch companies with their headquarters in Amsterdam, Rotterdam or some other city in the Netherlands. In the latter, the tax is on the distributed profits, while in East India the tax is on the profits realised there. To prevent double taxation, the Netherlands allows a deduction of two-thirds of the amount of the dividend distributed out of profits made in Netherlands East India. Serious difficulties arise in determining what part of the profit was made in that country. To facilitate the allocation of profit as between the home country and East India, the administration of the latter maintains in the Netherlands a body of expert accountants to examine the books of the head office (with the consent of the taxpayer), and controversial questions are frequently settled by consultation between the authorities of the two administrations.

146. So difficult are the questions of allocation encountered by the Netherlands East Indian administration that a department of accountants has been organised with special training in this field. The administration has informed foreign enterprises that a declaration based on the results of properly kept local accounts will serve as a basis of assessment, but the accounting staff frequently finds it necessary to examine the accounts pertaining to the total operations of the foreign enterprise in order to verify the declaration of local profits, and even to apportion profits in the ratio of the relative importance of the establishment in Netherlands East India in the enterprise as a whole.¹

147. No problems are presented in the case of great industries which produce raw material or staple products exclusively in Netherlands East India and sell them on local or foreign exchanges, as the total profit realised is allocable to Netherlands East India. Problems arise, however, in the case of enterprises whose products for some reason or another have no quotation in the world market, or have to undergo a certain process before they are ready for consumption. The increasing importance of the sales efforts abroad under the present conditions of the economic depression have

¹ *Infra*, paragraph 232 *et seq.*

constrained the administration to study intensively the structure of the business outside of Netherlands East India in order to determine more accurately the extent to which the sales organisation has exercised its influence in realising the profit. There are many conflicting views as to the appropriate apportionment of profits derived from purchasing in Netherlands East India and selling abroad. The views of the administration with regard to the apportionment of profits to local production or buying establishments and also as to the apportionment of profit between the foreign manufacturing plant and a local sales establishment will be described in detail below when the allocation of profits to such establishments is discussed.¹

148. The administration of Netherlands East India is cognisant that, in many instances, the book-keeping and accounting of a branch may be absolutely complete and perfect, but it cannot be taken as a basis for the profit derived in that country. Such is the case when it is impossible to verify the fairness of the invoicing of the head office or branches abroad to the branch in Netherlands East India. In such cases, the authorities resort to the empirical methods of assessment described below or to a fractional apportionment.

Japan, Mexico and Cuba.

149. These countries likewise look to the accounts of the local establishment as a basis for assessment, provided of course they are adequate. As in other countries, the administrations of these States encounter their greatest difficulties in assessing income when goods have been transferred to or from the local establishment, or when there have been interlocking or complicated transactions between the local establishment and those in other countries. The Japanese administration makes every effort to prevent evasion of tax by shifting the profits to other countries, but its general practice is to require the submission of only those accounts which reflect the business of the local establishment and its relations with the other establishments of the enterprise. The methods of checking which are employed by the administration may be summarised as follows: (1) acquiring a clear understanding of the course of business between the foreign parent and the Japanese establishment; (2) analysing in detail the interlocking transactions and the method of internal accounting; (3) taking an independent market quotation for similar goods or the price at which similar goods are sold by the foreign enterprise to an independent customer in Japan; and (4) making a comparison with similar businesses.

Spain and Switzerland.

150. The Spanish law prescribes fractional apportionment as the exclusive method. Nevertheless, if a foreign enterprise conducts its branch in Spain as an independent enterprise and reflects in its books the true profits, the amount thereof will be taken as the numerator in the fraction fixing the percentage which represents the relative importance of the local branch of the entire enterprise.

151. In Switzerland, according to the federal constitution, the twenty-two cantons, of which three are divided into demi-cantons, making a total of twenty-five jurisdictions, have each sovereign rights in levying taxes on property and/or income. Moreover, within certain cantons there are communes or districts which impose taxes on property or income. The communes or districts, however, follow as closely as possible the principles observed in levying cantonal taxes. The prevailing method of allocating income as between the cantons is that of fractional apportionment.² In the case of foreign enterprises having branches within the Swiss cantons, certain cantons apply the

¹ *Infra*, paragraphs 413, 422, 429, 440, 455 *et seq.*

² *Infra*, paragraph 221 *et seq.*

method of separate accounting, whereas others employ the method of fractional apportionment, the latter category including Basle-Urban, Berne, Geneva and Zurich.

States in the United States of America.

152. Under the Wisconsin income-tax and the New York personal income-tax, the assessment may be based on the profits revealed in the separate accounts of the local branch, provided the taxpayer convinces the authorities that they are satisfactory. Otherwise, they may determine the profits of the branch by applying the formulæ for fractional apportionment provided in their respective laws.

153. For the purpose of the Wisconsin levy, which is a pure income-tax, a special form is provided for those who report their income on the basis of a separate accounting. This form is a summarised income statement consisting of three columns. The first column is designated as "Wisconsin business", the second as "outside business" and the third column as "total business". This schedule is used for the purpose of comparing different items of income and expense in order to detect any large variations in the amounts or ratios thereof. Should any large variation occur, it may be due to the diversion of income from Wisconsin or unwarranted loading of expenses against the establishment in that State. Such variations will be made the subject of office correspondence or a field audit if necessary. The reverse side of this form¹ affords a reconciliation between the books and the tax returns in the same columnar order, and the total book income is checked against the balance-sheet which forms a part of the return. In some cases, the tax authorities require that balance-sheets be drawn up in the same columnar plan, but this has not yet become a standard requirement.

154. Although the Massachusetts excise-tax on corporations and the New York corporate franchise-tax prescribe apportionment formulæ, they may be set aside if the taxpayer proves that an assessment on the basis of a separate accounting is more reasonable.²

EMPIRICAL METHODS.

155. When there is no separate accounting for the local branch of a foreign enterprise, or if accounts are kept but the authorities consider that they do not reflect the true income of the local establishment, then the practice in the great majority of States is for the authorities to endeavour to make an assessment on some empirical basis. Even countries such as Spain, which normally assess a local branch by means of fractional apportionment of the total net income, sometimes resort to empirical assessments when they cannot obtain the necessary information concerning the total net income of a foreign enterprise or other data which are needed for the purposes of apportionment.

Summary of Empirical Methods.

156. Although empirical methods vary considerably with the nature of the enterprise and the character of the data available, the tendency of the majority of local tax officials is to make a comparison with other foreign or national enterprises which are engaged in the same sort of business. The method most frequently employed in the case of industrial and commercial enterprises is what may be termed the percentage of turnover method. This percentage may represent either the

¹ "Taxation of Foreign and National Enterprises" (Wisconsin Report), Vol. III, page 243.

² *Supra*, paragraph 74.

percentage of net profit to gross receipts of similar enterprises, or the percentage of gross profit to gross receipts, and, in the latter case, from the amount of gross profit thus computed the expenses of the local establishment — *e.g.*, rent, salaries, etc. — are deductible.

157. Another method is to ascertain the amount of capital invested in the local enterprise and to assume that it realises a gross profit equal to the current rate of interest on the capital invested. Still another is to ascertain the expenses of the local establishment, and to assume that it is making a certain profit over and above that amount.

158. In some instances, the authorities will examine the assets of the business and consider its nature and merely estimate a lump sum (*Pauschbetrag*) which will represent the profit for the year or for an agreed number of years. If all else fails, some authorities base an assessment upon mere exterior signs of the establishment.

159. In every country, the taxpayer is ordinarily given the right to appeal against this empirical or estimated assessment within a given period; but, in order to secure this reduction, it is necessary for him to submit local, and sometimes home office, accounts and all other evidence that may be required to convince the administrative or judicial tribunal that a reduction in the assessment is justified.

Percentage of Turnover Method.

160. Empirical methods are so flexible, consisting essentially in estimating income on the basis of the best data available, that little more can be said except in regard to the percentage of turnover method. It is specifically authorised as a first aid to the British assessing authorities.

United Kingdom.

161. The Income-Tax Act, 1918, General Rule 8,¹ authorises the taxation authorities, when the true amount of profits of the non-resident person cannot readily be ascertained, to charge the non-resident on a percentage of the turnover of the business done by or through the local establishment. This method is resorted to in about one-fifth of the total cases.

162. Obviously the operation of the "percentage of turnover method" varies with the nature of the case. If the United Kingdom establishment is an important branch of the foreign enterprise, an attempt is usually made to obtain particulars of the total profits and total turnover of the enterprise, so as to ascertain the percentage applicable to the whole concern. Even if the United Kingdom establishment is engaged in activities similar to those of the foreign enterprise — for example, marketing the products, or both manufacturing and marketing a particular product — the percentage ascertained for the whole concern is applied to the turnover of the establishment in the United Kingdom. It more frequently occurs, however, that the United Kingdom establishment merely markets a product which has been manufactured abroad, and, in such a case, it is

¹ Income-Tax Act, 1918, General Rule 8, reads as follows :

"Where it appears to the commissioners by whom the assessment is made, or, on any objection or appeal, to the general or special commissioners, that the true amount of the profits or gains of any non-resident person chargeable with tax in the name of a resident person cannot in any case be readily ascertained, the commissioners may, if they think fit, assess and charge the non-resident person on a percentage of the turnover of the business done by the non-resident person through or with the resident person in whose name he is chargeable as aforesaid, and in such case the provisions of this Act relating to the delivery of statements by persons acting on behalf of others shall extend so as to require returns to be given by the resident person of the business so done by the non-resident person through or with the resident person, in the same manner as statements are to be delivered by persons acting for incapacitated or non-resident persons of profits or gains to be charged."

customary to take a percentage less than the percentage for the whole concern, in order to allow for a manufacturing profit which is allocable to the foreign country. The amount of the fraction depends on the nature of the business. Where small branches or agencies are involved and information concerning the total results of the enterprise are not available, the percentage of turnover is generally fixed by making a comparison with enterprises in the United Kingdom engaged in the same class of business or with similar foreign enterprises for which a percentage has already been ascertained. Obviously, the percentage of turnover method is restricted primarily to manufacturing, producing and merchanting concerns. Although as a rule the percentage is fixed for each particular business, in one or two instances the authorities have fixed a common percentage for a number of concerns engaged in a certain class of trade and operating under similar conditions in a particular area. Once a percentage has been fixed it may be continued for a number of years. In exceptional instances, a fresh computation is made every year.

Other Nations in the British Commonwealth.

163. Similarly, recourse to assessment on the basis of a percentage of turnover is authorised by the Irish Free State Income-Tax Act when the local accounts of the foreign enterprise are insufficient to reflect the true income. The Irish Free State administration has reduced to a formula the practice described above. Thus, where the foreign enterprise has an important branch in the Irish Free State, the profits attributable to the establishment in the Irish Free State may be computed from the calculation :

$$p = \frac{P}{T} \times t.$$

T represents the turnover of the entire enterprise and *t* that of the Irish Free State branch. In some cases P will be taken as the net profit of the whole concern and *p* will then normally be the net profit of the Irish Free State branch. In other cases, where, for example, there is reason to believe that the Irish Free State expenses are much greater or less proportionately than the local expenses in other places, the gross profit of the whole concern would be taken as P and the resultant *p* would be taken as the gross profit of the Irish Free State concern. An allowance of the actual expenses in the Irish Free State, together with an allowance for a proportion of admissible head-office expenses (calculated probably on a turnover basis), would then be given in arriving at the profit assessable. It is to be noted that the case can be worked exactly in this way only if the activities of the Irish Free State establishment and of the foreign concern are alike — for example, if both are engaged in the “ merchanting ” only of a given product, or if both are engaged in the manufacturing and the selling of the product.

164. Similarly, in British India, when unable to reach an assessment on the basis of the local accounts of the foreign enterprise, the authorities frequently resort to the percentage of turnover method, authorised by Rule 33 pertaining to the Income-Tax Act (XI of 1922).¹ In Canada, however, the authorities are rather inclined to test the fairness of the billing prices of the foreign enterprise to the local sales establishment by requesting information concerning the cost of manufacture or arriving at a fair price through discussions with the taxpayer. Where this is impossible, the authorities sometimes apportion the total net income in the ratio of Canadian to total sales.²

165. The South-African Income-Tax Act provides that, in the case of foreign shipping companies and all businesses of sending messages by submarine cable or wireless apparatus, the assessment may be made either on the basis of accounts or by the percentage of turnover method.

¹ *Supra*, paragraph 36, footnote.

² *Intra*, paragraph 245.

United States of America.

166. To facilitate checking income-tax returns of mercantile enterprises, the Bureau of Internal Revenue of the United States has compiled percentages of net income to gross sales for various classifications of business. When the books of the foreign mercantile enterprise are not kept satisfactorily, or when an analysis of income based upon them indicates the possibility of a diversion of profit through arbitrary shifting of income to other countries, the authorities may use the appropriate percentage as a working argument with the taxpayer in seeking to develop further facts which will permit the determination of the net income through adjusting accounts.

Continental Europe.

167. Likewise the French authorities, if convinced of the inadequacy of the accounts of the local establishment, ordinarily turn at once to the method of estimating net income either on the basis of applying to the turnover the average percentage of net profit made by similar enterprises, or by multiplying the turnover by the coefficient of gross profit of similar French undertakings and in the latter case subtracting from the result the overhead charges of the establishment, plus, in principle, a portion of the expenses of the head office of the foreign concern which is attributable to that establishment, as well as a proportion of the expenses for services of general value to the foreign concern as a whole.

168. The percentage of turnover method is employed apparently with less frequency in most of the other countries. It may be used as one of the methods in making a comparison with other enterprises in Belgium. In Italy, the authorities do not expose it as one of their regular panoply of devices for arriving at a fair assessment of true income.

169. Although the Austrian law contains no provisions fixing a general percentage of turnover to represent taxable profits when endeavouring to arrive at a fair estimate of income by comparison with the results of similar enterprises taxable on the basis of regular accounts, the authorities sometimes fix a percentage by a friendly agreement with the taxpayer and allow him to make arrangements to avoid simultaneous taxation in Austria and abroad. The Polish authorities fix each year for each class of industry or commerce, in accord with the representatives of the different organisations, average rates of profits which are resorted to as a basis of assessment when accounting fails. Making a comparison with the rate of profit of similar enterprises is resorted to in the Grand-Duchy of Luxemburg, in Latvia and in Roumania.

170. In the laws of Germany, there is found a provision that, when necessary, the income can be estimated by a comparison with similar independent enterprises, provided the amount is equivalent to interest at the current rate on the capital invested in the local establishment¹. The Greek administration reports that, in the largest number of cases, the only factor definitely known is the turnover of the foreign enterprise in Greece, and that the other elements necessary for ascertaining the profit are difficult to verify. Consequently, the profit taxable in Greece is very frequently determined by multiplying the turnover by a coefficient. The minimum and maximum coefficient is fixed for each branch of industry by a special agreement and the fiscal authorities select for each case the coefficient which they believe to be the most appropriate within the minimum and maximum limits. In determining the coefficient, the fiscal authorities take into consideration the usual profit realised by similar national enterprises. Nevertheless, the foreign enterprise may prove that its real profit is inferior to the minimum fixed, subject, on the other hand, to the fiscal authorities proving that the real income is superior to the maximum fixed in the table. Examples of these coefficients are as follows : dealers in automobiles, 7 to 17 per cent ; dealers in grain, 2 to 6 per cent ; dealers in drugs, 4 to 14 per cent.

¹ The same provision is found in the laws of the Free City of Danzig.

Netherlands and Netherlands East India.

171. Although there is apparently little occasion to resort to the percentage of turnover method in the Netherlands, this method is frequently made use of in Netherlands East India. The administration of that country prefers, however, to apply to gross receipts the percentage of gross profit realised by similar business undertakings, from which local expenses are deducted, rather than to apply a percentage representing net profit. The administration contends that the latter method is not to be recommended, as it is not sufficiently exact and is likely to neglect differences in costs of doing business in the various countries in which the enterprise has branches. The book-keeping of the local branch should show the actual expenditure in Netherlands East India.

Other Countries.

172. The percentage of turnover method is rarely employed in Japan, and its use as a method in the other countries studied seems to be the exception rather than the rule.

FRACTIONAL APPORTIONMENT.

173. By fractional apportionment is meant dividing the total net income of an enterprise, or of two or more of its departments, in a certain ratio, for the purpose of determining the taxable income of the local establishment in a given country. More specifically, the net income subject to apportionment may be the total net income of the enterprise regardless of the sources or transactions to which it pertains, and, for convenience, this method will be called unlimited fractional apportionment. On the other hand, the net income subject to apportionment may be that derived from specific combinations of activities, such as manufacturing and selling, and, for convenience, this method will be called limited fractional apportionment. Although the law and practice of a given country may envisage unlimited fractional apportionment, in practice the apportionment in a given case may be limited. It is necessary to sub-classify these main categories of apportionment in accordance with the underlying theories or the factors employed in effecting the apportionment.

Summary of Methods of Fractional Apportionment.

174. Perhaps the broadest concept of apportionment employed by any country is that contemplated by the Spanish law which requires that a foreign enterprise with a branch in Spain be taxed by applying to the total net income a percentage or comparative ratio (*cifra relativa*), representing the importance of the local establishment in the enterprise as a whole. The Spanish Profits Jury (*Jurado de utilidades*) has the widest discretionary powers in determining this ratio, but, in given cases, may resort to such concrete factors as the proportion of local property to total property or of local turnover to total turnover. This method of apportionment may be termed unlimited apportionment according to relative importance.

175. Although not much used by the French administration in assessing the tax on the profits of a branch of a foreign company, fractional apportionment is the method prescribed in computing the taxable quota (*quotité imposable*) of the dividends and interest distributed by the foreign company which are deemed to be paid out of income earned in France. The tax on income from securities (*impôt sur le revenu des valeurs mobilières*) is imposed by the Registration Bureau (*Bureau de l'Enregistrement*) on that part of the total dividends and interest paid, which is determined by the ratio of assets in France to the total assets of the company, and the term "assets" (*biens*) is given the widest interpretation. In practice, the factors actually employed may be real property

in the case of an industrial enterprise or turnover in the case of a mercantile enterprise, or some combination of these or other factors.

176. The system of allocation or apportionment applied by the Swiss cantons in the case of enterprises carrying on inter-cantonal or international business is, in general, that of apportioning the total net profit in the ratio of the productive elements of the local establishment to those of the whole enterprise. This method may be termed apportionment in the ratio of productive elements. These elements include, *inter alia*, plant, machinery, accounts receivable and pay-roll capitalised at the rate of 10 per cent.

177. The Netherlands East India tax administration sometimes in practice employs, when the separate accounts of the local establishment are insufficient, a method of apportionment of total net income which is essentially the same as the Spanish method, although the factors employed are in some instances more abstruse, consideration being given to such intangible items as the importance of sales effort. This method may be classified under the same heading as that employed in Spain — namely, apportionment in accordance with relative importance.

178. British India law¹ provides for recourse to fractional apportionment on the basis of receipts when the income of a non-resident cannot be ascertained, and this method is sometimes used. Although apportionment of total net income of a foreign enterprise is authorised in South Africa,² it is seldom employed. When it is used, the entire income of the enterprise is considered in order to determine the fraction, which is to represent the Union taxable income. This entails reviewing the accounts of the business as a whole just as if the assessments were being made on the basis thereof, and elucidations are obtained from the branch officials, who are under the jurisdiction of the Union courts. If the necessary information or explanation of items is not obtainable, the Commissioner resorts to his power to make estimative assessments.

179. Outstanding examples of limited apportionment are found in the treaties between Austria and Czechoslovakia and Austria and Hungary. They provide that, if goods are purchased in one country and sold in the other, the income arising from such transactions shall be divided in the ratio of 50 : 50. On the other hand, if an enterprise manufactures in one contracting State and sells in another, the total net income arising from such transactions shall be apportioned in the ratio of two-thirds to the State of manufacture and one-third to the State of sale.

180. The regulations for the United States income-tax provide a method of fractional apportionment to be employed in the case of income arising from production or manufacture within the United States, or *vice versa*, when it is impossible to determine an independent factory price, or when the books of the taxpayer do not show a fairer allocation. The income derived from production and sale is divided into two equal parts, and one-half is apportioned in the ratio of property used in producing and selling the article sold, and the other half is apportioned in the ratio of sales of the article produced.

181. A very important category of limited apportionment is that employed in various American States, the nature of the limitation varying. Wisconsin employs fractional apportionment when there is no adequate separate accounting, the apportionment being limited to the balance of income not definitely allocable. Massachusetts excludes certain items of total net income and apportions the balance. Fractional apportionment is also the method prescribed by the New York franchise tax on business corporations, but, because of the complexity of the prescribed formula, its application

¹ Income-Tax Act, 1922, Rule 33, *infra*, paragraph 238.

² Act 40 of 1925, Section 19.

is usually supplanted in practice by a discretionary assessment of the Tax Commissioner. In Wisconsin, the factors are real and personal tangible property, manufacturing cost and sales. The factors in the Massachusetts formula are real and personal tangible property, salaries and receipts. The factors prescribed by the New York law are the average monthly value of real property and tangible personal property, the average monthly value of bills and accounts receivable arising from defined transactions, and the average value of the stocks of other corporations allocated to New York in the ratio of physical property situated within and without that State. The New York State personal income-tax on individuals prescribes a formula to be employed in the event that the separate accounting of a local branch is insufficient, the factors being the average value of real property and tangible personal property, salaries, and gross sales or charges for services.

182. In short, fractional apportionment may be considered a primary or basic method in Spain, in Switzerland (as regards the practice of the principal cantons), in Austria, Czechoslovakia and Hungary (under the treaties described) and in various States in the United States. France uses it in determining the quota of dividends and interest distributed by a foreign corporation which is subject to the tax on income from securities. Otherwise, fractional apportionment is a secondary method, being employed only when assessment on the basis of separate accounting, subject to verification, or various empirical methods are considered inadequate. Such is the case in France with regard to the commercial profits tax, and in Germany. Fractional apportionment is rarely used, however, by the various British administrations, the United States, or in most other countries where the authorities prefer to base their assessment on the accounts of the local establishment, subject of course to verification and, if necessary, to the selection of certain data contained therein which make possible an empirical assessment. Italian law does not permit of the application of fractional apportionment in any case, the assessment of income having as its sole basis the income actually produced in the Kingdom by the branch or subsidiary independently of the total net income of the foreign enterprise. The same is true of Estonia, Latvia, Poland and Roumania, and also of Cuba and Mexico.

183. In view of the ever-growing complexity of the structure of international enterprises and the apparent difficulties encountered by many in maintaining an accounting system which will reflect the true profits of each establishment, whether conducted as a branch or a subsidiary company, there is a tendency on the part of tax officials to resort more and more to fractional apportionment. As will be discussed further on in connection with subsidiary enterprises, a number of tax administrations are disposed to regard local subsidiaries as "dummies" or fictitious entities designed to set up artificial legal barriers in the way of the assessment of true profit. In some cases, the authorities look upon the enterprise as a whole, disregard the prices at which goods have been billed from one establishment to another or at which services have been charged, and re-allocate or apportion as they see fit the income of the entire enterprise to the local branch or subsidiary. To the reconstructed accounting, some method of fractional apportionment is applied. It is therefore essential to study the underlying theories and the factors employed in fractional apportionment by different countries in order to select, if possible, that method or combination of methods which is soundest from a theoretical and practical viewpoint.

Unlimited Fractional Apportionment.

Spanish System.

184. As the method of fractional apportionment is the normal procedure for taxing foreign enterprises operating in Spain, the Spanish system will be first discussed. Until 1920, the Spanish branches of foreign companies were, in general, taxed on the basis of the income shown by their

accounts.¹ As many branches showed little or no profit, the Spanish Government was forced to develop another system that would subject foreign enterprises to a tax burden equivalent to that imposed on Spanish enterprises. The Spanish report states that the guiding principle in the reform was the establishment of a system which would meet the "100-per-cent test" — *i.e.*, which would not result in subjecting to tax in all countries more than 100 per cent of the profits of the entire enterprise. Moreover, the basic principle of the Spanish law is that the tax is to be imposed on the real profit; if, therefore, each branch of an enterprise is taxed as an independent unit, the result may be that a branch will be taxed whereas the entire enterprise realises a loss, and consequently the enterprise will be taxed on more than its real profit.

185. The Spanish report asserts that, during three years, a study was made of Spanish companies which revealed that the taxation of each branch as a separate establishment would result in a tax 16 per cent greater than that which would be obtained if the enterprise were taxed as a unit. The Spanish report observes that accounts will not show the income of a branch unless they are arranged for that purpose; but the majority of foreign enterprises established in Spain maintain their accounts for other purposes, in general legitimate, but which are not of a nature to show results satisfactory to the Spanish administration.

186. It was felt that, if one maintained the basis of taxing according to accounts, it would be necessary to interfere with the liberty of enterprises. The most difficult point was the control of the prices charged by the parent enterprise to branches or subsidiaries. Except for certain articles which have a broad market, these prices are not subject to control without resorting to arbitrary methods. The author of the report asks how the Spanish administration could control the cost price of factories producing hundreds of different objects and which would be situated in a distant country.

187. Furthermore, the most rigorous surveillance of the administration over the affairs of private enterprises would not permit the determination of the extent to which the branch or subsidiary company was administered with absolute economic independence, or was treated as a part of the entire enterprise and managed in its general interest. All the *entrepreneurs* were unanimously of the opinion that, even if the profits of a branch of an enterprise were correctly accounted for, the accounting would not show the real economic significance of the branch in the entire enterprise.

188. The same was true of an enterprise which formed part of a community of interests (*communauté d'intérêts*). In dividing the total profits of a group of enterprises forming a community of interests, one resorted rarely to the profits as shown by the accounts. This experience was confirmed by the development of concerns (*Konzerne*). Consequently, if the Government were to tax branches or subsidiaries in accordance with their real economic significance, it would be necessary to employ methods analogous to those employed for the division of profits between enterprises in such a group.

189. It is the existence of these concerns and their international operations which reduces to an absurdity, according to the opinion of Spanish experts, the system of separate accounting in a large number of cases. An example is given of a certain group of enterprises in which each enterprise establishes its accounts according to identical principles agreed to in advance. This accounting must show clearly the profits of each enterprise, but under other articles of the agreement all of these profits are pooled and finally redistributed in proportion to the capital

¹ "Taxation of Foreign and National Enterprises", Vol. I, page 143 *et seq.*

stock in circulation. If in such cases, which become more and more numerous, the Spanish administration was bound to follow the accounts, it would take as a basis for taxation, not the real profits realised by the company, but an account of profits that it no longer possesses — that is to say, a figure absolutely imaginary. The Spanish legislature has therefore decided to apply to the taxation of the enterprise belonging to a concern the same principles of allocation as are in reality employed by the concern.

190. The Spanish report also emphasises that cases of dumping must be especially considered. If the enterprises of one country force their branches or subsidiaries abroad to sell with little or no profit, or even at a loss, in order to increase the prices at home, the true rôle and significance of these branches and subsidiaries abroad will be absolutely ignored if they are judged by the small profit or loss that they make. It is for these reasons that the Spanish legislature has established the present system, which consists in always dividing the total revenue of the enterprise between the different countries in which it carries on business.

191. Spanish experts have agreed that there are a certain number of cases where the profits of an enterprise can be approximately determined without resorting to arbitrary methods and that the formula adopted should be large enough to allow for such cases. The problem has been solved by dividing the total profits of the enterprise in such cases in proportion to the profits of the various branches. Thus the system of apportionment and the system of direct assessment give the same result. This group of cases comprises principally commercial establishments, and, in particular, banks of deposit. It is in this field that branch accounting has an extended recognition in the Spanish regime.

192. With regard to subsidiary companies, if the operations realised by an enterprise through a non-autonomous agent occasioned liability to tax under Spanish law, it was clear that, from an economic viewpoint, there is no agent less autonomous than a subsidiary company. There was so much fraudulent evasion through using subsidiary companies that opinion on this point was unanimous. The jurists in the Spanish Parliament, however, insisted that the law define precisely the cases in which the administration would have the faculty of declaring that a company which was independent from a juridical viewpoint was, in fact, only a branch of another company or enterprise.

193. The conditions imposed are as follows : in the first place, the administration must make a declaration that the Spanish company forms a unit with the foreign enterprise, and that declaration can be made only if the Spanish company is in one of the situations regarded as indicating such a relationship.¹ If the company accepts that declaration or, in the case of a refusal, if the competent tribunal confirms the attitude of the administration, the Spanish company is subjected to tax as if it were a branch of the parent company.

194. Difficult problems are presented by deductions made by the Spanish company from its income in order to make payments of various kinds to the foreign company, and which result in diverting the profits of the former. The principal deductions are the following : royalties for patents and trade-marks ; important technical services ; engineering and commercial services ; plans and supervision. The commercial services include primarily the services of contracts of purchase and sale on the one hand and of financial services on the other.

195. The Spanish law does not contain any concrete rules for dividing the profits of an enterprise, but has established a committee of experts, which is formed by two representatives of

¹ *Infra*, paragraph 395.

banking institutions, the Director-General of Public Revenue, the Director-General of the Stamp and Registration Taxes, the head of the Department of Special Taxes on Companies and an expert of recognised authority. The law calls this committee a "jury", because it may only decide on the economic facts relative to the proportion of the profit realised in Spain, expressed as a percentage of the total income of the enterprise during a given period. This period is three years, but the enterprise has the right to request a revision if, during it, an important change has occurred in the business in Spain.

196. The decision of the jury is communicated to the taxpayer and, if he refuses to conform to it, he is free to set forth his reasons. The Finance Minister gathers all the information he considers necessary and submits the question to the Council of Ministers. Any information submitted to the jury must be kept secret.

197. As an example of the application of the Spanish system, if a branch or subsidiary is administered in a way to assure for itself the largest possible profit, the commission of experts takes as a basis a relative figure. If the branch realises a profit of 2.5 million pesetas and the total profit of the enterprise in the same period, computed in accordance with Spanish law, is 33 million French francs, which, at the rate of exchange on the date of fixing the balance-sheet, makes 10 million pesetas, the commission of experts fixes the relative figure of that enterprise at 25 per cent — *i.e.*, 25 per cent of the total profits of the enterprise are taxable in Spain — which makes a taxable profit of 2.5 million pesetas.

198. If a Spanish subsidiary does not come within the requirements for treating it as a branch of the foreign company, it is taxed in the same manner as any other Spanish company.

199. The verification of the accounts of the foreign company is made under the same conditions as that of national enterprises. The balance-sheet and the accounts and records of the mother company must be authorised by competent representatives of the company and their signatures legalised in the ordinary manner. A large number of foreign enterprises, having their centre of management in a country in which accountants are recognised, submit the certificates of such accountants with their accounts. The commission of experts attaches much value to the assessments made by the fiscal administration of the country to which the foreign company belongs. Moreover, the commission of experts always takes into account the differences in the concept of income in the laws and regulations of the interested countries.

200. If the commission of experts has the unanimous conviction that the branch or subsidiary is administered with complete economic autonomy but that its accounts are not sufficient to reveal the Spanish profit, it may resort to indirect methods; but, even in this case, the administration seeks only to tax the real Spanish profit of the branch or subsidiary company. In some cases, where the branch or subsidiary company is managed with absolute economic independence and has a satisfactory accounting, the administration does not rely on the accounts. This is especially true where enterprises manufacture in a foreign country and sell in Spain. The Spanish administration seeks to separate the sales profit from the manufacturing profit without going into the question of the cost of manufacture. The apportionment of the sales profit in Spain and other countries is then made on the basis of the respective volume of business, taken separately or in combination with other factors in order to take into account the special situation of the different national markets in which the enterprise operates. This special consideration of the different situations of markets is very important in Spain, because the phases of the Spanish economic cycle are, as a general rule, behind those of other countries.

201. If the Spanish administration is aware that the branch or subsidiary is not managed in an autonomous fashion but in the interest of the entire enterprise — that is to say, if there is an

economic unity between them — the apportionment of profits is made on the basis of the actual facts. In the case of a subsidiary company, the administrative officials make the necessary declaration, and, if it is accepted or upheld, the commission of experts endeavours to determine the relative importance of the subsidiary in the concern as a whole. Such declaration is not necessary in the case of a branch.

202. The commission of experts takes into account the particular circumstances of each case and chooses its method in accordance therewith. There is no formula or rule of thumb. Nevertheless, the commission follows certain general criteria, the most important of which are the following : in the first place, the jury asks itself, does the Spanish establishment form a part of a concern in which the profits will be pooled in order to be subsequently distributed according to certain agreed methods ? If this is the case, the commission of experts calls upon the legal representatives of the enterprise to communicate the agreed rules of distribution. The enterprise is advised that it is not obliged to furnish information if it feels it should not do so, and, if submitted, the information is kept secret.

203. Having been advised of the plan of distribution, the commission of experts apportions the profit in accordance therewith. If the enterprise does not belong to such a concern, the jury itself establishes a plan of distribution and proceeds in the spirit of business men who would actually effect such a distribution. For this purpose, the jury asks itself if the operations of the Spanish establishment are of the same nature as those of the foreign establishment of the same enterprise.

204. If the business of the Spanish establishment is similar to that of the other establishments of the foreign company, the relative importance of the Spanish establishment is determined in accordance with the importance of its operations. For example, in the case of a manufacturing enterprise in which the fixed capital is preponderant, then the real assets come first into consideration. Nearly always other factors are taken into account, such as the pay-roll, the raw materials, the frequency of the services rendered by the enterprise, the expenses, rent, sales, etc.

205. If, on the contrary, the enterprise is engaged in selling or in similar transactions in which the liquid capital plays a preponderant rôle, it is the turnover which is almost always used as a basis of assessment, together with one or several of the factors which have just been mentioned. It has been stated above that the economic cycle in Spain does not synchronise with that abroad. That difference is in every case taken into account where it exercises an appreciable influence on the business of the enterprise in question.

206. As a general rule, the facts which should serve in making the assessment are indicated by the very nature of the enterprise, but difficulties arise in some cases. In such cases, the interested parties are invited to discuss their situation with the experts of the jury, which is empowered to call in disinterested experts. According to the Spanish report :

“ If the facts in question conform to the conditions required for the application of the method, recourse is had to mathematical statistics in order to determine the exact value of the facts proposed as a measure of the company's business operations. ” ¹

207. The great difficulties with which the jury must deal are those in cases where the enterprise has in Spain establishments which carry on operations different from those of the other

¹ “ Taxation of Foreign and National Enterprises ”, Vol. I, page 150.

establishments abroad. The most frequent cases of this nature are those in which the enterprise has its manufacturing establishment abroad and merely sells in the Spanish establishments the merchandise produced by the former, and *vice versa*. The Spanish method excludes systematically, as a futile and valueless detour, the determination of the cost price. It therefore remains to determine what is the respective economic significance of manufacture and of sale in the entirety of the enterprise. Important examples of enterprises of this class include those which acquire some famous brand of sherry wine for which they themselves establish the production and sale on all the markets of the world. Again, there is the example of mining enterprises.

208. It is possible to determine for a given quantity of goods the profits of production for a series of years, usually three, and, by making the same calculation for the sale, one ascertains the relation between the profits of production and the profits of sale for the given quantity of products. This relative figure is then employed to effect the apportionment.

209. In other branches of commerce there is established in practice a certain rate of commission which includes certain sales expenses. It is then necessary to determine what is the part of the risk and of the expenses which falls on the producer ; if the risk is negligible, then the method applies with great exactitude and the division between the manufacturing profit and sales profit is thus realised. In a more important category of cases, embracing enterprises which manufacture and sell articles through establishments which perform only one of the two operations, the jury approaches the problem in the same manner as it would when taxing a concern representing a vertical organisation, including the sale of goods.

210. The methods employed by the jury are exactly analogous to those employed in business practice, and it is because of such cases that the Spanish legislature recognised the necessity of placing on the jury important Spanish financiers and other experts with a great experience. When these experts have studied the particular case and have made a first attempt to find the most just formula, they call on the representatives of the enterprise either to appear in person or to send in a written report, and the experts of the jury discuss with these representatives the proposed formula. If a disagreement occurs, disinterested experts are called. One seeks to deal directly with them in the absence of the representatives of the enterprise in order that third parties may not obtain more knowledge than is necessary of the situation of the enterprise. Very frequently it is possible to decide the question by the employment of " mathematical statistics ".

French System.

211. The system of fractional apportionment is also regularly employed by France in the imposition on foreign companies of its tax on income from securities (*impôt sur le revenu des valeurs mobilières*). The reason for this imposition is that French companies are required to withhold at source a tax on dividend and interest payments, in addition to the tax assessed on its industrial and commercial profits as such. To place a foreign company exploiting property in France in a similar situation, and to reach that part of its distributed income which is deemed to have been derived from French sources, the foreign company is required to pay this tax on the same proportion of the dividends distributed or interest paid at its seat abroad as its assets in France bear to its total assets. This taxable quota (*quotité imposable*) is fixed for a period of three years, and the tax is due in respect of dividends distributed or interest paid during each fiscal year of the company. It is presumed that the taxable proportion of these payments has been derived from French sources, even though, in fact, during the year in question, no income was received from such sources. On the other hand, if the foreign company makes no such payments, no tax is due, even though the French branch or subsidiary was productive of revenue.

212. The French report¹ declares that this method of taxation is essentially arbitrary and has the advantages and disadvantages of such a method of assessment. The administration must employ it even when disadvantageous, and companies must submit to it even when its results do not conform to the real state of affairs. The French report observes that this method protects the fisc from operations tending to reduce the profit realised in France, and also, for the purposes of this tax, frees the branches or subsidiaries in France from investigation, except for the valuation of the French assets or business in determining the taxable quota.

213. In determining the taxable quota, the respective value of French assets and total assets on the basis of the balance-sheets established for France and the general balance-sheet is ascertained. This value is the real or sales value of all assets without deduction of any debts or charges affecting them. Nevertheless, to obtain the value of the French assets and that of the total assets, it is not sufficient to add the assets of each balance-sheet and to determine the proportion. It is also necessary to ascertain if each of the items corresponds to a real asset and to eliminate those which represent only suspense accounts (*comptes d'ordres*), such as the cost of first establishment.

214. It is furthermore necessary to verify if the assets listed under the same heading in the two balance-sheets have a certain nationality and if they belong to each installation, and to withdraw those which have an uncertain nationality or which are common to the French and foreign exploitations, such as the value of a patent or industrial process; in this case, one presumes that these assets form part of the French assets in the same proportion as the other assets.

215. In order to give the taxable quota its arbitrary (*forfaitaire*) character, the authorities examine the balance-sheets of the three preceding years to determine the average of the variable values (merchandise in stock, cash, debts, bills of exchange, etc.). To this average is added the value of the real assets at the close of the last balance-sheet, and, on the basis of the total thus obtained, the proportion between the value of French assets and the value of the total assets is established.

216. The indications on the balance-sheet serve most frequently as a basis for fixing the taxable quota, subject to the right of verification by the administration. If it is established, for example, that French real estate has been entered in the balance-sheet at a valuation much lower than its real worth, the administration has the right to substitute therefor an estimated value, taking into account the appreciation of the French assets. In the same way, foreign companies may, on the condition of submitting necessary evidence, demand an increase in the valuation over that indicated in the balance-sheets of certain of their foreign assets, in order that the proportion serving as a basis for the taxable quota may more nearly approach reality.

217. When the foreign company does not establish a special balance-sheet for its French exploitation, it is invited to make its own valuation, subject to the right of verification by the administration, of the part which the value of the French assets represents in the different headings of its general balance-sheet. In this way, there is established for the French branch a fictive balance-sheet, which is used to make a comparison of the assets of the branch with those of the entire enterprise.

218. If a foreign company has a French subsidiary, the taxable quota is established in the same manner, but only that part is taken as the comparative value of the French assets which corresponds to the rights of the foreign company in the subsidiary. Thus, if the foreign company

¹ "Taxation of Foreign and National Enterprises", Vol. I, pages 80 and 81.

possesses eight-tenths of the shares of the French company, the value of the French assets is eight-tenths of the estimated value of the assets of the French company. The estimate of the value of the assets of the French company is most frequently made on the basis of the balance-sheet of that company ; but if this company has attributed to its shares, notably for the purpose of payment of taxes due, an estimated value superior to that which results from the indications on its balance-sheet, it is that estimated value which will be taken to determine the worth of the capital stock, and, consequently, the value of the participation of the foreign company.

219. When a foreign company merely sells merchandise in France and has there no other industrial assets, the taxable quota is fixed in accordance with the relation existing between the amount of its French transactions and that of its total transactions. The nationality of the transaction is determined by the place where the contract is concluded.

220. Where a foreign company rents real estate in France in order to manufacture there merchandise intended for sale, the taxable quota is fixed by comparing the value of the French assets with those of the total assets used by the company and the amount of the French transactions with the total transactions. The average between these two proportions is taken as the taxable quota.

Swiss System.

221. Switzerland offers a wealth of experience in the application of the method of fractional apportionment in connection with enterprises having establishments in two or more of the twenty-five cantons and demi-cantons, each of which has its own fiscal legislation. The situation in Switzerland is similar to that between countries, inasmuch as each canton or demi-canton taxes the foreign enterprise in accordance with its own particular law and practice, which would inevitably result in double taxation were it not for the principles that have been established by the Federal Tribunal for preventing the duplication of levies. The Federal Constitution, Article 46, paragraph 2, prohibits double taxation as between the cantons and accords taxpayers the right to bring before the Federal Tribunal every violation of the article cited. From the numerous decisions that have been rendered by this Tribunal in the field of inter-cantonal taxation there have been disengaged principles which indicate a procedure for the cantons to follow. The cantons often apply the same principles of allocation in cases of foreign enterprises, although they are not obliged to do so under the cited constitutional provision. Nevertheless, the application of the inter-cantonal principles to international cases affords the cantons the advantage of a uniform practice and spares them the difficulty of seeking special rules which are often difficult to find. ¹

222. Little guidance in allocation is found in the fiscal legislation of the cantons themselves, such laws containing, in general, merely the principle that foreign enterprises will be taxed on the profit attributable to establishments within the canton. The second general principle found in the laws of many cantons is the exemption or only partial taxation of establishments conducted abroad by cantonal enterprises. Only a few cantons have established legal provisions governing the allocation of taxable property and income, the most detailed of such provisions being found in the law of Geneva, which distinguishes between cases of inter-cantonal and international double taxation. The provisions of the laws of Basle-Urban and Zurich are less detailed ; those of Zurich distinguish between inter-cantonal and international cases, but those of Basle-Urban do not take that difference into account. ²

¹ "Taxation of Foreign and National Enterprises", Vol. II, pages 441 and 442.

² See Basle-Urban, Section 1, paragraph 3, "Gesetz v. 23 Juni 1921, betr. die Besteuerung der anonymen Erwerbsgesellschaften"; Berne, Section 6, "Dekret v. 22 Januar 1919, betr. die Veranlagung sur Einkommenssteuer"; in the sense of the "Dekret v. 16 November 1927"; Geneva, Article 28, paragraph 2, Article 43, paragraph 2, Article 63 of the "Loi du 24 mars 1923, sur les contributions publiques"; Zurich, Section 11,

223. As indicated above, the cantons, in view of the lack of specific legal provisions on the subject, frequently apply to international cases the precepts laid down by the Federal Tribunal for application in intercantonal cases. There have been few cases of litigation in the international field, this being due to the fact that such cases are often settled in accordance with administrative discretion, the arrangement proposed by the taxpayer being seldom refused, if suitable, to the tax collector.

224. As the inter-cantonal situation may reflect what would seem to be the situation between separate countries, the methods employed in inter-cantonal cases will be first discussed. The system applied in connection with property taxes is not altogether the same as that applied in taxing income. As a rule, each canton is authorised to tax that part of the property located on its territory, the term property including land and buildings, machinery, furniture, stocks of merchandise and the like contained in the buildings. Other kinds of property are apportioned between the interested cantons in the ratio of the part of the property definitely located in the canton and the total property of the enterprise.¹ The latter kind of property consists principally of cash, bills of exchange, securities, bank deposits, accounts receivable and participations in other enterprises.² The majority of the cantons base their taxation on a proportionate part of the total income, whether Swiss or foreign, of the enterprise, these cantons including Basle-Urban, Berne, Geneva and Zurich. The method of separate accounting, however, is not barred in principle by the Federal Tribunal in inter-cantonal cases if the accounting of a branch shows approximately the figures corresponding to the actual part of the income of the entire enterprise pertaining to the branch.³ Such a case may arise if the branch is managed as an enterprise independently of the seat, which is a very exceptional case.⁴ In international cases, although the method of separate accounting is not, in principle, applied by the leading cantons, that accounting nevertheless has a great value in determining the importance of the branch and may therefore furnish, if kept correctly, certain necessary elements in the determination of the ratio in which the income is apportioned between the interested fiscal jurisdictions. Such factors are principally land and buildings, machines, furniture, stocks of raw materials and merchandise, salaries and turnover. The verification of these factors does not offer difficulties.

225. The principle of primary importance imposed by the Federal Tribunal is that, when an enterprise maintains establishments in different cantons, each canton may not impose the special income of each establishment, but only a part of the total net profit. That part corresponds to the proportion between the productive factors in the canton and all the productive factors of the enterprise. In a given case, the apportionment may be effected in the ratio of the manufacturing costs,⁵ the turnover,⁶ or other elements in the particular case.

paragraph 2, Section 24, paragraph 2, Section 33, paragraph 2, "Gesetz v. 25 November 1917 betr. die direkten Steuern".

¹ See *Recueil des arrêts du tribunal fédéral*, 1910, Vol. I, No. 2 ; 1911, Vol. I, Nos. 52 and 54.

² The debts of the entire enterprise are deducted proportionately to the property attributed to a canton. This last rule is subject to exceptions resulting from cantonal law, especially in cases where cantons tax only certain kinds of property, or where they tax the gross value of immovables or prohibit the deduction of any kind of debt. In the case of corporations, this method of allocating property involves the taxation of a proportionate part of the capital and reserves. When taxing foreign enterprises, some cantons consider only objects situated within their territory ; but, in accordance with the jurisprudence of the Federal Tribunal, the majority tax local property and, in addition, a proportionate part of the rest of the property of the enterprise. That part of total indebtedness is deductible which is determined by the ratio of the gross value of the property of the branch and the gross value of the total property of the enterprise. Such is the procedure notably in Basle-Urban, Geneva and Zurich. For a more complete description of property apportionment, see "Taxation of Foreign and National Enterprises", Vol. II, pages 443 and 444.

³ *Recueil des arrêts du tribunal fédéral*, 1923, Vol. I, page 33.

⁴ *Recueil des arrêts du tribunal fédéral*, 1924, Vol. I, page 87.

⁵ *Recueil des arrêts du tribunal fédéral*, 1911, Vol. I, page 272 ; 1914, Vol. I, page 214.

⁶ *Recueil des arrêts du tribunal fédéral*, 1916, Vol. I, page 130.

226. In order to take account of the influence exercised in the production of income by the central management of an enterprise, an influence which is expressed insufficiently or not at all in the productive factors, the Federal Tribunal has authorised the canton of the seat to impose a *préciput* of the profit varying between 10 and 25 per cent.

227. In the case of an industrial enterprise, the productive factors are : on the one hand, the installation serving in production — such as land and buildings, machinery, tools, furniture, autos, stocks of raw materials or merchandise, as well as the assets consisting of cash, bills of exchange, securities, accounts receivable and the like — and, on the other, the factor of labour represented by salaries and wages. The definitely allocable factors are attributed to the establishment to which they belong ; the other assets are distributed proportionately to the ratio of the definitely allocable factors, or possibly attributed to the establishment to which they belong from an economic viewpoint.¹ The value of immovable and movable property is the same as that used for the purposes of the tax on property. Salaries and wages are capitalised at the rate of 10 per cent and attributed to the establishment which pays them. The total of the productive factors attributed to the establishment in a canton is the numerator of a fraction, of which the denominator is the total of all the productive factors of the enterprise. This fraction represents the part of the income that the interested canton may tax.

228. The following example explains fractional apportionment as it is generally applied by the Federal Tribunal :

	Total of productive factors	Productive factors in the canton	
		A.	B.
CAPITAL.			
<i>Localised factors :</i>			
Manufacture (raw material, articles in process of manufacture, etc.)	329,611	329,611	—
Merchandise	243,338	—	243,338
Machines and tools	25,000	25,000	—
Furniture	10,000	5,000	5,000
Installations, instruments, autos	15,000	15,000	—
Immovables	34,800	34,800	—
	657,749	409,411	248,338
	100 per cent	62.2 per cent	37.8 per cent
<i>Other assets, non-localised :</i>			
Cash, postal cheques, bills of exchange, accounts receivable	143,309	90,433	54,876
	100 per cent	62.2 per cent	37.8 per cent
LABOUR.			
Salaries and wages capitalised at 10 per cent	4,770,107	4,121,372	648,735
	5,573,165	4,621,216	951,949
	100 per cent	82.92 per cent	17.08 per cent

¹ *Recueil des arrêts du tribunal fédéral*, 1926, Vol. I, pages 246 and 250.

229. In the preceding case, the manufacturing and technical direction are in canton A, the commercial direction and the commercial part of the enterprise in canton B. Of the profit realised, a *préciput* of 15 per cent was attributed to canton B, the importance of the commercial part not finding adequate expression in the percentage obtained in the basis of the productive factors ; and a *préciput* of 5 per cent was attributed to canton A to account for the technical direction. After thus deducting 20 per cent from the total net profit, there remained 80 per cent to apportion. Canton A had therefore the right to impose 5 per cent, plus 0.8×82.92 per cent = 71.34 per cent ; and canton B, 15 per cent plus 0.8×17.08 per cent = 28.66 per cent of the total income of the enterprise. The income is calculated differently by the two cantons, each computing it in accordance with its own legislation.

230. The apportionment of income of commercial enterprises is generally effected in the ratio of turnover. This principle has been confirmed by the Federal Tribunal in a decision of February 14th, 1930.

231. Turning to international cases, the principal cantons, including Basle-Urban, Berne, Geneva and Zurich, apply the same method as that employed in inter-cantonal cases. The foreign enterprise is required to submit all the data necessary for the fiscal authorities to determine its total income. If the local establishment is incorporated, it will generally be treated as an independent enterprise unless it functions as an organ of the foreign company, in which event it may be treated as a branch.

Netherlands East Indian System.

232. In taxing enterprises producing or purchasing in Netherlands East India and selling without, or manufacturing or purchasing without that country and selling within, the tax authorities generally consider the relative importance from an economic viewpoint of each of these activities. As regards the great industries operating exclusively in Netherlands East India in the production of raw materials or staple products and selling them on the world markets, the whole of the net profit thus derived is ascribed to Netherlands East India, but difficulties are encountered in assessing foreign enterprises, the products of which have no regular quotation on the world markets and have to be processed to a certain extent before they are ready for consumption. In the past, a reasonable assessment has been reached on the basis of a comparison with the sale of raw material by other enterprises or by an estimate of the influence of the manufacturing process on the price received. The apportionment has been complicated by the recognition of the increasing importance of sales activities outside Netherlands East India in competition with other enterprises. The authorities therefore consider it urgent to study intensively the structure of the entire business, so as to be able to decide whether a part of the total profits should be attributed to the sales organisation because of having a permanent influence in making the profit.

233. In the case of foreign companies which buy or produce in Netherlands East India, the tax authorities find little assistance in the books of the local establishment, because of the company regarding it merely as an item of expense, not considering that buying as well as selling are factors in the making of profits. In other instances, no matter how complete and perfect the book-keeping of the local branch may be, the authorities consider that the accounts may not be taken as a basis for calculating the net income and cite as an example the case where it is impossible to verify the invoicing of the head office or branches abroad to the sales branch in Netherlands East India.

234. Although the authorities as a general rule endeavour to assess the net profit on the basis of the declaration and book-keeping of the local branch of the foreign enterprise, if this book-keeping is insufficient, recourse may be had to the empirical methods already described or to fractional apportionment, the predilection being for the latter.¹ The authorities endeavour to secure copies

¹ "Taxation of Foreign and National Enterprises", Vol. III, page 150, paragraph 82.

of the head office accounts, showing the total net profit of the foreign enterprise, in order to make an analysis of the structure of its business and the possibilities of making profit in Netherlands East India as compared with the other countries in which the taxpayer operates, and to ascertain what part of the total profit should be taken as a minimum to represent the so-called East Indian profit. The fixing of this proportion may be facilitated by making a comparison with other businesses. Another method is to take the net results of the entire enterprise as a basis and calculate the amount that should be allocated to the activities of the enterprise abroad and therefore excluded from the assessment. In the case of some mercantile enterprises, apportionment in the ratio of turnover is considered the most practical method.

235. Taxpayers have often urged apportionment of profits on the basis of wages paid for labour performed in obtaining the profits. Their theory is that the carrying on of a business consists in the organic use of the means of production — that is to say, labour, soil and capital — and that the two latter elements ought not to be taken into consideration for the allotment of profit. The tax authorities have rejected, in principle, this basis for the apportionment of profits on the grounds that the wage scale varies so greatly from country to country that it cannot be taken as a common basis for comparing the profit-earning capacity of the branches in the different countries, and also that in the case of many enterprises producing raw materials, their very life is due to the soil, climate and other circumstances peculiar to Netherlands East India. For example, Netherlands East India in 1931 produced 90 per cent of the world supply of cinchona, from which quinine is made, and the tobacco of Sumatra has a certain quality which is not found elsewhere.

236. It has therefore been settled definitely that the pay-roll in different countries cannot be taken as a basis for the apportionment of profits.¹ Other criteria are evolving, such as that of apportioning the income of a foreign enterprise which buys at its head office in Europe and sells in Netherlands East India, in the ratio of 25 per cent to the buying office and 75 per cent to Netherlands East India. It is admitted that these figures may vary for each individual concern.

237. The success of the method of fractional apportionment necessarily depends on the ability of the administration to verify the general results of the business. They admit that such verification should be restricted to a written explanation of the items in the annual accounts and written answers to certain questions about the system of valuation of stock, depreciation and general overhead account, reserves, and the like. Delicate questions are always presented by the manner in which the head office charges the local branch with supplies, services and overhead expenses. The examination of the principal book-keeping is usually only possible for Dutch companies operating in Netherlands East India, for which purpose the administration of the latter country maintains expert accountants in Holland.

British India System.

238. Not infrequently, when the local accounts of a foreign enterprise are insufficient for the determination of income, the British India income-tax officer has recourse to a method of fractional apportionment provided in Rule 33 of the Income-Tax Rules.² This Rule provides, *inter alia*, that, in any case in which the income-tax officer is of the opinion that the actual amount of the income, profits and gains, accruing or arising to any person residing out of British India, whether directly or indirectly, through or from any business connection in British India, cannot be ascertained, the amount of such income may be calculated on an amount which bears the same proportion to the

¹ "Taxation of Foreign and National Enterprises", Vol. III, page 150, paragraph 85.

² *Supra*, paragraph 36, footnote 4, "Taxation of Foreign and National Enterprises", Vol. III, page 36, paragraph 96.

total profits of the business of such person (such profits being computed in accordance with the provisions of the Indian Income-Tax Act) as the receipts so accruing or arising bear to the total receipts of the business. Thus, in the case of an enterprise manufacturing or purchasing abroad and selling in India, the effect of this method is to allocate the entire net profit derived from such transactions to British India, thus carrying out Section 42 (3) of the Act, which requires that the total net profit pertaining to merchandise sold in British India shall be allocated there without any allowance for a manufacturing or purchasing profit to be allocated abroad. When employing the fractional method, the authorities usually check the accounts of the foreign enterprise by examining the accounts printed or published in accordance with the requirements or practice in the home country, or by requesting certified copies of the accounts of the parent concern.

Other Cases of Unlimited Fractional Apportionment.

239. The application of the method of unlimited fractional apportionment in countries other than those mentioned above is the exception rather than the rule, being resorted to when separate accounting or the more easily applied empirical methods fail to yield satisfactory results. Thus, when the German administration finds it necessary to use this method, it apportions the total net income on the basis of factors which are of primary importance in the earning of profits, but there are no special rules, whether statutory or administrative, governing the choice of the factors which are to be employed. The selection is within the discretion of the competent fiscal authorities, whose decision must depend on what is just and fair. In the case of enterprises in general, and in the case of commercial enterprises, including banks, the ratio of gross receipts realised in Germany to total gross receipts is employed. In the case of insurance companies, either the preceding method is used or the ratio of premium income in Germany to total premium income. For other kinds of enterprises, the fiscal authorities apply the ratio of salaries and wages paid in Germany to total salaries and wages paid, excluding directors' percentages (*Tantiemen*) paid out of profits. If the preceding factors cannot be ascertained, or do not provide a reasonable basis for apportionment, the assessing authorities select factors according to the circumstances of the particular case. The above general observations apply as well to Danzig, the tax system of which is modelled after that of the German Reich.

240. Similarly in the law of the United Kingdom, there is no provision for fractional apportionment, but it may be employed as a last resort in some cases when the method of separate accounting or of taxing on a basis of a percentage of turnover fail to yield satisfactory results. For example, tax-collectors have considered assessing the local profits of foreign banks by applying to the total net profits the ratio of assets in the United Kingdom to total assets. Belgium and Luxemburg also use this method when others fail.

241. In the Netherlands, fractional apportionment of total net income is employed only in the case of insurance companies and upon their request.

242. In the rare cases when the Greek administration employs this method, it usually determines the ratio of net income to gross of the enterprise as a whole, and applies this percentage to the branch in Greece. The Greek administration prefers, however, a more analytical method by considering the positive and negative elements which influence the determination of net income, thus comparing, according to the case, the commissions, interest or insurance premiums received, the sales of exported products, the general overhead, interest, commissions paid out, rates of depreciation, reserves, etc. Sometimes a comparison of the capital employed in Greece to that of the entire enterprise is considered.

Limited Fractional Apportionment.

243. The outstanding characteristic of the various methods of fractional apportionment in this category is that the income subjected to apportionment is generally that which is not susceptible to definite allocation — for example, that arising from production of goods in one country and their sale in another. Broadly speaking, the administrations first examine the accounts of the enterprise, allocate to their definite source such items as rents, dividends and interest, and then apportion the balance of the income, derived from the joint operation of an establishment within the country and another establishment without the country by means of an apportionment in the ratio of fixed or especially selected factors.

244. The methods included in this category may be sub-classified under the headings: (1) the Canadian method; (2) the Austrian method; and (3) American methods. The method employed in Canada will be briefly described, because it exists only in the practice of the administration, but is in accordance with the principle which is carried out through more detailed provisions in Austria as well as in the United States and some of its component States — for example, Wisconsin, Massachusetts and New York.

Canadian Use of Fractional Apportionment.

245. Although the Canadian tax administration is accorded the widest discretion in assessing foreign enterprises, it endeavours to observe to the fullest possible extent the principles of jurisdiction of Anglo-Saxon common law. Thus, if the authorities consider it necessary to resort to an apportionment of income, they exclude all the items of income of the enterprise which can be definitely allocated as being derived from sources other than its main business, and take into account only those which have a direct connection with the activities of the branch. This same observation applies to deductions for expenditure. Suppose an enterprise manufactures abroad and sells at its branch in Canada. With regard to the commercial activities, the authorities examine the billing price to the branch and, in order to test its fairness, may request information concerning the cost of manufacture. If the price is shown to be unfair and the authorities cannot arrive at a fair price by discussion with the taxpayer, they often resort to apportionment on the basis of the ratio of sales in Canada to total sales. They include, however, in the denominator of the fraction only the income of the entire enterprise which has a direct reference to the joint activities of the enterprise and the Canadian branch.

Austrian System.

246. The Austrian system is essentially the same as that employed in Canada, in that the accounts of the foreign enterprise are first examined, and it is only those items of income derived from activities carried on jointly with establishments in other States that are subject to apportionment. There are two regimes of apportionment, the one applicable under the Austrian tax law to all foreign enterprises with the exception of those subject to the other regime, which is prescribed by special treaties with Czechoslovakia and Hungary. The former, which we may term for convenience "the tax law regime", consists in requiring that a certain fraction of the profits derived from the joint activities of establishments within and without Austria be taxable in Austria. The treaty regime converts these minima into arithmetical apportionment fractions.

Austrian Law.

247. The tax law regime¹ stipulates as the minimum taxable in Austria a fraction of the profits due to the joint activity (*gemeinsame Tätigkeit*) of the Austrian establishment and the foreign centre of management. Thus, if a foreign manufacturer sells through an establishment in Austria goods which he has manufactured abroad, at least one-third of the profits from these joint operations shall be liable to Austrian tax. If the foreign enterprise purchases goods abroad and sells them in Austria, at least one-half of the joint profits are allocable to the latter country, without regard to the difference between the wholesale and retail price. If the foreign enterprise manufactures in Austria and sells abroad, the law requires that at least two-thirds of the joint profit be ascribed to the Austrian factory. If the enterprise purchases goods in Austria for sale abroad, then one-half of the joint commercial profit is taxable in Austria. Although other types of establishments belonging to an industrial or mercantile enterprise, such as processing establishments or research or statistical establishments or display-rooms, give rise to assessments, no specific fractions are provided for use in their case. The special accounts of the local branch are used as a basis for assessing such types of establishments.

248. Minima are prescribed as well for Austrian enterprises belonging to individuals and partnerships subject to the general profits tax, which is assessable on at least one-fourth of the total net profit, and companies subject to the company tax, on at least one-tenth of the total net profit. These minima, which are ascribed to the seat of management, are based, however, upon the total net income of the enterprise and not on income derived from activities carried on jointly with establishments outside Austria. The seat quota (*Sitzquote*) is founded on the theory that a national enterprise operating abroad nevertheless enjoys the same protection and advantages as an enterprise operating exclusively in the home country.

Austrian Treaties with Czechoslovakia and Hungary.

249. The first attempts to regulate allocation were in the arrangements between Austria and Hungary in the days of the old Austro-Hungarian Monarchy.² These arrangements provided that, with regard to credit and insurance companies, the country in which the enterprise had its centre of management should determine, in accordance with its own laws, the profits to be ascribed to the separate establishments in each country. The figure thus determined was binding on the other country, which signified that the country in which the branch was situated had indirectly to submit to the legislation of the other. It also meant that an administrative decision of one State had immediate legal effect in the other State, which was considered to be incompatible with the full autonomy of two independent States. As Czechoslovakia and Hungary became independent States after the war of 1914, it was necessary in the above-mentioned agreements with those countries to establish a system which avoided all encroachment by administrative acts of one State upon the authority of the other. The post-war arrangements provided, therefore, that the fraction of total profits to be taken as a basis for apportionment by each administration is to be fixed by agreements between the two Governments. Although the authorities of each State may determine the total income, an endeavour was made to avoid discrepancies through giving each other a large measure of mutual assistance. These treaties, like other double-taxation treaties concluded by Austria with various European countries, apply the principle that the contracting States shall limit their taxation of enterprises to business done in the country itself. In principle, this implies that the contracting parties waive their right, under their own domestic law, to assess on the basis of a certain minimum

¹ Law on Personal Taxation, Section 90, paragraph 3; "Taxation of Foreign and National Enterprises", Vol. II, pages 29 and 30.

² Agreement for the Avoidance of Double Taxation, *Imperial Law Gazette*, No. 278, 1907. "Taxation of Foreign and National Enterprises", Vol. II, page 36.

fraction of total profits, whether in respect of the seat of the enterprise (by way of exception, the fiscal treaty between Austria and Hungary allots a minimum to the seat of enterprises liable to the company tax) or of the separate establishments. As the Austrian treaties with other countries do not provide any specific criteria for allocating profits, and merely provide for the conclusion of special allocation agreements with other contracting parties, the special arrangements with Czechoslovakia and Hungary are considered to be a great improvement over the treaty regime with other States.

250. The first of these post-war arrangements was that with Czechoslovakia, there being many enterprises dating from pre-war days which had establishments in both countries which were formerly all one State. Many of these establishments were so closely connected that it was very difficult to work out accounts for the separate establishments in each country in a manner to meet fiscal requirements. In view of the urgent need for allocation agreements, the two countries concluded a fiscal treaty.¹ Further arrangements² were made concerning special allocation methods for credit and insurance companies and stipulated the procedure in assessing enterprises having establishments in both States.

251. The fiscal treaty with Hungary³ was likewise supplemented by special agreements,⁴ and completed later by administrative regulations⁵ modelled after the arrangements with Czechoslovakia.

252. These arrangements regulated the taxation of profit-seeking enterprises maintaining establishments, on the one hand in Austria, and, on the other, in Czechoslovakia or Hungary. It is immaterial whether the owner of the enterprise is an individual, partnership or company. The establishments in the two countries must belong to the same owner, but such ownership is not as a rule assumed to exist when the operations in one country are conducted by a separate corporation or company with legal personality, even though the shares are held by the owner of the enterprise operating in the other country. Furthermore, the arrangements are, as a rule, only effective if the establishments in each country are a part of the same business undertaking — that is to say, are engaged in the same branch of industry and are interdependent.

253. Although not expressly stipulated in the agreements, the system is, in practice, confined to enterprises which keep regular books. In cases where it is doubtful whether the allocation provisions should apply, it is necessary to reach a settlement by special arrangement between the two administrations.

254. With regard to the most important business enterprises, those engaged in manufacturing and selling, banking and insurance, the total profit, as determined by each administration in accordance with its own fiscal regulations, is apportioned to the separate establishments in each country in accordance with specified ratios.

255. *Rules for Manufacturing and Commercial Enterprises.* — The following rules of allocation were laid down, taking as a basis the minimum quotas used in Austrian and Czechoslovak fiscal practice :

In the case of the sales office of a manufacturing establishment situated in the other country, the commercial profit assessable against the office is one-third of the total profits from its sales.

¹ Promulgated by Austria in the Decree of the Federal Minister for Finance, Austrian *Federal Law Gazette*, No. 3, 1923. "Collection" C.345.M.102.1928.II, page 21 *et seq.*

² Decree of Federal Minister for Finance, Austrian *Federal Law Gazette*, No. 18, 1929.

³ Austrian *Federal Law Gazette*, No. 437, 1924. "Collection" C.345.M.102.1928.II, page 46 *et seq.*

⁴ Decree of Federal Minister for Finance, Austrian *Federal Law Gazette*, No. 439, 1924.

⁵ Austrian *Federal Law Gazette*, No. 35, 1930.

If the sales office also makes purchases, its share is increased to one-half.

If purchases are made by the establishment in one country and sales effected by the office in the other country, the total profit from these operations is divided equally between the two.

256. The profit derived from the joint activities of the two establishments and allocable according to the above rules is determined from the total results of the enterprise on the basis of the ratio of the joint turnover of the two establishments to the total turnover of the enterprise. If profits are earned exclusively by the activities of a single establishment, the amount thereof is ascertained from the total results on the basis of the ratio of the turnover of such activities to the total turnover of the enterprise. Such profit is then subject to no further allocation. The different currencies are converted at average rates of exchange fixed according to special rules.

257. The above method of allocation may be illustrated by the following example. The owner of an enterprise has a factory in Prague and a commercial establishment in Vienna. The articles manufactured at Prague are sold partly by the establishment at Prague, partly by the Vienna establishment. On the other hand, foreign products are bought by the Prague establishment and again are sold partly by that office, partly by the Vienna office.

	Schillings
Total turnover of the enterprise (S)	1,800,000

Made up as follows :

Sales of enterprise's own manufacture by office in Prague (S ₁)	500,000
Sales of enterprise's own manufacture by office in Vienna (S ₂)	800,000
Sales of foreign products by office in Prague (S ₃)	300,000
Sales of foreign products by office in Vienna (S ₄)	200,000
Total profit (T) determined according to fiscal regulations	270,000

Calculation from Viewpoint of the Austrian Fiscal Administration.

Joint profit :

1. From manufacture :
$$\frac{S}{S_2} = \frac{T}{x}$$

$$x = \frac{S_2 T}{S} = \frac{800,000 \times 270,000}{1,800,000} = 120,000 \text{ schillings.}$$

Of which one-third goes to Vienna = 40,000 schillings,

Two thirds go to Prague = 80,000 schillings.

2. From purely commercial business :
$$\frac{S}{S_4} = \frac{T}{x}$$

$$x = \frac{S_4 T}{S} = \frac{200,000 \times 270,000}{1,800,000} = 30,000 \text{ schillings.}$$

Of which half goes to Vienna = 15,000 schillings.

Half goes to Prague = 15,000 schillings.

Exclusively Czechoslovak profit :

• Equals total profit less joint profit — that is,
270,000 schillings — (120,000 schillings plus 30,000 schillings) = 120,000 schillings.

Allocable entirely to Prague, 120,000 schillings.

Allocation of total profit between Vienna and Prague :

	Schillings
Vienna profit = 40,000 schillings plus 15,000 schillings	= 55,000
Prague profit = 80,000 schillings plus 15,000 schillings plus 120,000 schillings	= 215,000
Total profit	270,000

258. *Rules for Banks and Insurance Companies.* — In the case of branches of banks, that proportion of the total profits of the enterprise is allocated to the branch which corresponds to the ratio between the pay-roll of the branch and the pay-roll of the whole enterprise. In the case of branches of insurance companies, an allocation is made according to the ratio between the annual net premiums (after deduction of dividends or bonuses) paid to the branch and the total net premiums of the enterprise.

259. *Rules for Other Kinds of Enterprises.* — If a branch (in other than the above-mentioned cases) acts on behalf of a branch situated in the other country — such acts contributing towards the total results of the enterprise (*e.g.*, an information office) — the profit from those activities is deemed by the State where they are exercised to be the customary business commission. This rule, however, does not meet every case, so that the agreement, despite its detailed character, is incomplete. Its completion depends upon future developments.

260. *Exceptions.* — Profits are, in principle, allocated according to the ratios agreed upon. The agreements, however, provide for the following exceptions :

(a) The fiscal authorities of each country may agree to allocate according to the closed accounts, if allocation on this basis gives substantially the same results as are to be expected from allocation according to the above ratios.

(b) If the allocation ratios are obviously at variance with the actual results of operations, the fiscal administrations may, in a particular case, agree upon another ratio after first hearing the views of the taxpayer.

261. *Allocation Procedure.* — In applying the allocation arrangements, the fiscal authorities follow a special procedure in order to assure as much uniformity as possible in the use of the ratios. The officials responsible for assessment in each country communicate to each other the necessary fiscal data and furnish each other with any necessary legal assistance. The officials in the country who first undertake an assessment of the taxpayer's profits send the fiscal data to the authorities of the other State, which refrains from assessing until these data have been received. If the enterprise is subject to the company tax, the assessment is undertaken by the authorities of the State in which the enterprise has its seat of management. If the enterprise is liable to the general tax on profits (*i.e.*, owned by an individual or partnership), the assessment is begun by the authorities of the country where the central accounts of the enterprise are kept, or, in default of accounts, by the authorities of the country in which the owner of the enterprise resides. Cases not falling under these rules — for example, where a partnership (*offene Handelsgesellschaft*) keeps no accounts and its members reside in different countries, the two fiscal administrations agree as to who shall proceed with the assessment.

262. To prevent delay, certain time-limits have been imposed. The authorities who initiate the assessment must communicate directly to the assessment authorities of the other State, within six months after expiration of the period for making declarations, figures which they have ascertained representing total profit, and the profit allocable to each establishment, the taxable profit, the total turnover and the turnover of each establishment. In practice, all material obtained for assessment purposes is communicated. Similar data secured in making subsequent changes in the

assessment must also be sent. Within three months after receiving this data, the assessment authorities of the other State must issue an assessment notice for the fiscal period to which they refer. If the communicated data are insufficient, special investigations can be made under the general agreement for legal assistance.¹ The authorities initiating the assessment must, if requested, extend the time-limit for appealing against a decision given on the basis of its allocation to thirty days from the issue of an assessment notice by the other State. In this way, the allocation effected in the first State is kept from acquiring legal force until a decision has been rendered by the other State. If the authorities of one State fail to observe the time-limits for assessment, the authorities of the other State need wait no longer in instituting their own assessment or appeal procedure.

263. *Operation of Treaty Regime in Practice.* — The Austrian authorities report that the allocation agreements have worked smoothly, especially since the introduction in 1928 of arrangements for legal assistance between the assessment authorities. The reciprocal exchange of material necessary for determining profit has proved essential in applying the allocation ratios on uniform lines. The Austrian report cites as advantages of this system that it is unnecessary to verify the special accounts of local branches of the foreign enterprise, and check the price at which goods have been invoiced as between separate establishments. The report admits that the method sacrifices accuracy, as is inevitable under any method of averages, being based on the fiction that similar activities in different countries earn equal profits, which may be contrary to fact. Moreover, the Austrian report admits that, the ratios being fixed, they assume that in all branches of industry the separate stages of manufacture and commerce are in the same ratio of importance in producing profits, although this is by no means necessarily the case. For instance, this ratio may be different in the metal industry from that in the textile industry.

264. Although the Hungarian authorities express satisfaction in the working of their agreement with Austria, the Czechoslovak authorities criticise the treaty regime on the grounds that double taxation may still occur because each State computes the total net profit subject to apportionment according to its own internal legislation, which is different from that of the other State. For example, in the case of a company with share capital, the company tax in Austria is added to net profits as shown by the balance-sheet, whereas, in Czechoslovakia, the special profits tax is a deductible item. Thus, the basis of assessment is different in the two States, and the allocation quota adopted by the Austrian assessment authorities is proportionately larger than the quota taken in Czechoslovakia. To this objection the Austrian report replies that this does not constitute double taxation, but only means that the basis of taxation is determined more strictly under the laws of one country than under the laws of the other. This only affects the taxable quota of the country where the rules are stricter. A wholly Austrian enterprise is subject to this stricter computation of profits, and it is right that an enterprise half Austrian should be subject to the same rules of assessment in respect of its Austrian profits. The Austrian report further points out that this stricter assessment does not necessarily mean that the Austrian tax is heavier, for the Czechoslovak allowance of a deduction of tax from profits is counterbalanced by a higher rate of tax than that imposed in Austria. Another difficulty in the application of the Austro-Czechoslovak understanding is that the State which allows a special fiscal privilege applying exclusively to operations within its territory — for example, extraordinary depreciation of investments — can do so only up to the amount corresponding to the allocation quota. If the other State does not permit such items to be entered into the accounts used in its determination of apportionable income, the taxpayer may suffer hardship which can be mitigated only by special arrangements between the taxing authorities.

Treaty between Czechoslovakia and Poland.

265. A very different system of apportionment is embodied in the double taxation treaty

¹ Treaty on Legal Protection and Assistance in Fiscal Matters, Austrian *Federal Law Gazette*, No. 81, 1929.

between Czechoslovakia and Poland. Article 2 (2) provides that the total receipts of enterprises maintaining establishments in the two jurisdictions will be apportioned in the ratio of the invested and working capital belonging to each establishment ; and the expenses will be apportioned in the ratio of receipts. In particular cases, the Finance Ministries can agree upon another method of apportionment. Income realised in one State from the sale of merchandise bought in the other, as well as relative expenses, will ordinarily be apportioned in equal parts between the participating establishments.¹

United States Methods of Fractional Apportionment.

266. There are three instances in which fractional apportionment as between countries is authorised by the United States Revenue Act and Regulations : (1) where goods have been produced without and sold within the United States,² or *vice versa*, and an independent factory or production price has not been established,³ or the taxpayer does not request assessment on the basis of his regularly kept books of account which reflect taxable income more clearly than the other prescribed methods ;⁴ (2) in the case of foreign shipping companies not of countries which have entered into arrangements for reciprocal exemption of shipping profits,⁵ and provided the taxpayer does not ask to have its return based upon its regularly kept books of account, which show a detailed statement of receipts and expenditures reflecting more clearly than the fractional method the income from United States sources ;⁶ and (3) in the case of foreign life insurance companies which are taxed exclusively by apportioning to the United States a part of the total net income of the company, in the ratio of the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States to the reserve funds held by it at the end of the taxable year upon all business transacted.⁷ None of these methods is of great practical importance, because there is very little occasion to resort to them. Nevertheless, for purposes of comparison with the methods employed by other countries, such as Spain and Switzerland, there will be discussed in detail the method applicable to income from production without and sale within the United States in the following paragraphs, and those applying to insurance and transport companies when subsequently dealing with such types of enterprises.⁸

267. The outstanding characteristic of the method of fractional apportionment applicable to industrial and mercantile enterprises⁹ is that : (1) it is limited to the joint income of establishments within and without the United States, whether belonging to a foreign or a national enterprise ; and (2) that definite factors are prescribed by the Regulations. The few instances where other methods have failed and this method has been used with reasonable success have been in cases where tobacco or fruit has been grown, or base minerals have been mined in a foreign country and sold in the United States. In these cases, the situation of the taxpayer was such that the determination of an independent factory price was almost impossible. The Regulations take as the factors of apportionment : (1) the taxpayer's property within the United States and within the foreign country which is used in producing the goods sold ; and (2) the gross sales of the taxpayer within the United States and within the foreign country of the goods so produced. Before applying these factors, the joint net income from the operations within and without the United States is computed.

¹ " Collection " C.345.M.102.1928.II, page 53.

² Regulations 77, Article 682, Case 2A.

³ Regulations 77, Article 682, Case 1A.

⁴ Regulations 77, Article 682, Case 3A.

⁵ Revenue Act of 1932 or previous Acts, Sections 212(b) and 231(b).

⁶ Regulations 77, Article 683.

⁷ Revenue Act of 1932, Section 203 (c).

⁸ See paragraphs 506 and 534 respectively.

⁹ Revenue Act of 1932, Regulations 77, Article 682, Case 2A.

268. From the gross income derived from the sale of goods produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, or *vice versa*, there are deducted the expenses, losses or other deductions properly apportioned or allocated thereto and a rateable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income.

269. Of the amount of net income so determined, one-half is apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such half by a fraction, the numerator of which consists of the value of the taxpayer's property within the United States and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country.

270. The remaining half of such income is apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such half by a fraction, the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country.

271. The application of the formula is even more strictly limited by the definitions of "gross sales" and "property", as follows:

"The 'gross sales of the taxpayer within the United States' means the gross sales made during the taxable year which were principally secured, negotiated, or effected by employees, agents, offices or branches of the taxpayer's business resident or located in the United States.¹ The term 'gross sales' as used in this paragraph refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, and the term 'property' includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis. Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch or agent in the United States."

Special Provisions concerning United States Possessions.

272. As regards income from producing goods in a possession of the United States and selling them in the United States, or *vice versa*, there is a variation in the allocation formula which may

¹ This provision is subject to being amended because of its conflicting with the decision of the United States Supreme Court, which holds, broadly speaking, that income from the sale of goods arises where the contract is concluded. *Supra*, paragraph 62.

be used when an independent factory price or production price has not been established. Instead of including "property" and "gross sales", the formula keeps the factor of property as defined above, but apportions the other half of the net income in accordance with the total business of the taxpayer within the United States and within the possession. The portion thus attributable to sources within the United States is determined by multiplying such one-half by a fraction, the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

273. The "business of the taxpayer" is measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries and other compensation of employees and for the purchase of goods, materials and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales. Such expenses, purchases and gross sales are limited to those attributable to the production (in whole or in part) of personal property within a possession and its sale within the United States, or *vice versa*.¹ In contradistinction to the provision in the law² allocating the entire income from purchasing goods in a foreign country and selling them in the United States, or *vice versa*, to the country of sale, the Regulations provide³ that the net income derived from purchasing goods in a possession of the United States and selling them in the United States, or *vice versa*, shall be apportioned in the ratio of the "business of the taxpayer" (as defined above) in each jurisdiction.

Wisconsin Method of Fractional Apportionment.

274. In case the income of a foreign enterprise which is properly assignable to Wisconsin may not, in the judgment of the authorities, be determined on the basis of its separate accounting, the net income remaining, after exclusion of the definitely allocable items,⁴ is apportioned to Wisconsin on the basis of the ratio obtained by taking the arithmetical average of three ratios, which may be briefly described as tangible property, manufacturing cost and sales, the selection depending upon the character of the enterprise. If the enterprise "entitled to apportionment" of its income shows that the use of any one of the three ratios gives an unreasonable or inequitable final average ratio because of the fact that such enterprise does not employ, to any appreciable extent, in its trade or business in producing the income taxed, the factors made use of in obtaining such ratio, this ratio may, with the approval of the Tax Commissioner, be omitted in obtaining the final average ratio which is to be applied to the remaining net income.

275. The Wisconsin Statute⁵ defines the three ratios as follows :

" 1. The ratio of the tangible property, real, personal and mixed, owned and used by the taxpayer in Wisconsin in connection with his trade or business during the income year to the total of such property of the taxpayer owned and used by him in connection with his trade or business everywhere. Cash on hand or in bank, shares of stock, notes, bonds, accounts receivable, or other evidence of indebtedness, special privileges, franchises, goodwill or property the income of which is not taxable or is separately allocated, shall not be considered tangible property nor included in the apportionment.

¹ Regulations 77, Article 682, Case 2B.

² Revenue Act of 1932, Section 119 (e).

³ Regulations 77, Article 682, case 1B.

⁴ *Supra*, paragraph 67 *et seq.*

⁵ Wisconsin Statutes, 1927, Chapter 71, Section 71.02 (3) (d).

“2. In the case of persons engaged in manufacturing or in any form of collecting, assembling or processing goods and materials within this State, the ratio of the total cost of manufacturing, collecting, assembling or processing within this State to the total cost of manufacturing or assembling or processing everywhere. The term ‘ cost of manufacturing, collecting, assembling or processing within this State and everywhere ’, as used herein, shall be interpreted in a manner to conform as nearly as may be to the best accounting practice in the trade or business. Unless in the opinion of the Tax Commission the peculiar circumstances in any case justifies a different treatment, this term shall be generally interpreted to include as elements of cost within this State the following :

“ (a) The total cost of all goods, materials and supplies used in manufacturing, assembling or processing within this State regardless of where purchased ;

“ (b) The total wages and salaries paid or incurred during the income year in this State in such manufacturing, assembling or processing activities ;

“ (c) The total overhead or manufacturing burden properly assignable according to good accounting practice to such manufacturing, assembling or processing activities within this State.

“ 3. In the case of trading, mercantile or manufacturing concerns, the ratio of the total sales made through or by offices, agencies or branches located in Wisconsin during the income year to the total net sales made everywhere during said income year.

.....

“ 5. As used in this section the word ‘ sales ’ shall extend to and include exchange, and the word ‘ manufacturing ’ shall extend to and include mining and all processes of fabricating or of curing raw materials. If the income of any such person properly assignable to the State of Wisconsin cannot be ascertained with reasonable certainty by either of the foregoing methods, then the same shall be apportioned and allocated under such rules and regulations as the Tax Commission may prescribe.”

276. The Wisconsin authorities resort very frequently to the use of the formula, especially in the case of foreign enterprises which do not clearly show that they bill their goods manufactured outside the State to their branch in the State at the same price as that at which they would sell the same article to an independent purchaser. In fact, it is said that by far the larger number of important corporations transacting a portion of their business or owning some of their property in Wisconsin are required to file their returns on the apportionment basis. A special form is provided for showing the results of their business or property in Wisconsin and that everywhere, called “ Form 4B, Apportionment Data ”. The taxpayer indicates, first, its non-apportionable income, including that following the *situs* of the property and that which follows the residence of the recipient. Then follow the entries needed for computing the apportionment fraction : (a) tangible property used ; (b) cost of manufacturing ; and (c) sales. The term “ tangible property used ” means real, personal and mixed property exclusive of that yielding income listed under the head of non-apportionable income following *situs* of property under head 2 (a) of Form 4B. In other words, there should be entered under this head only those properties which are actually employed in the production of the apportionable income, not including idle properties and properties producing rent and royalties, the term “ tangible property used ” including land, the value of buildings, machinery, equipment, furniture and fixtures, less reserves for depreciation in each case, stocks of goods, goods in process, and raw material. The taxpayer uses the average values of the properties employed during the period covered by the return. The average values of inventories

can best be computed by taking the average of monthly balances. Depreciation reserve balances are reflected by deducting from the book values the accumulated depreciation reserves on the properties in question. Appreciation must be eliminated from book values. The term "cost of manufacturing" includes goods, etc., used, wages and salaries, and overhead or burden.

277. The apparent overlapping with regard to "goods in process" and "goods used" in the first two factors is explained in the following manner by the Wisconsin authorities: from the viewpoint of inventories, the tangible property in the apportionment fraction includes raw material, goods in process and finished goods on hand and in the total inventory at the end of the taxable year. Cost of manufacturing would include such raw materials as went into manufacture during the year. The schedule of tangible property separates finished goods, goods in process and raw material merely in order to have an analysis of the breakdown for comparative purposes. The finished product until sale is included in tangible property because, being in inventory, it is a part of tangible property. The Wisconsin Tax Commission has experienced little difficulty in computing the cost of manufacture, because manufacture is usually identical with specific units of property for which cost records are usually maintained. Trouble has been encountered only where goods have been partially processed within the State and completed without the State, or *vice versa*. Where substantial processing is done within the State, the Tax Commission has held that all raw material that goes into the processing done in Wisconsin is part of the cost of manufacturing in Wisconsin. It would seem, therefore, that any further processing outside the State would include only the direct labour, overhead, and such additional material as is used in the further processing of the item.

278. The factor of sales includes such sales as would come under the common definition of the term, including sales of by-products, but not as a rule including incidental sales of scrap and the like, which would be a reduction of the cost of manufacturing rather than a sales element, for the reason that the sales organisation does not ordinarily dispose of such products. The Wisconsin Tax Commission has held that the *situs* of the sale is the place where the sale is consummated from a regularly established office. Thus, if a corporation manufactures in Wisconsin and markets its products at branches outside the State, the managers of which have the power to consummate a sale without receiving the confirmation of the central office, then the sale takes place outside the State. On the other hand, if the same corporation sends travelling salesmen outside the State merely to solicit trade, the transaction is considered a Wisconsin sale. There is no uniform rule applicable to all cases, but, in general, the sale is regarded as taking place at the office which has power and authority to close the contract.

279. The ratio of the value of each factor within Wisconsin to its total value within and without the State is determined, and then the arithmetical average of these three ratios is computed. This represents the percentage of the total apportionable income attributable to the business activities of the corporation in Wisconsin. To the amount of income so apportioned to Wisconsin is added, or deducted as the case may be, any non-apportionable income or loss, having a definite *situs* in Wisconsin, this information being set forth in the upper section of Form 4B. The result thus obtained represents the total income taxable by Wisconsin.

Massachusetts Method of Fractional Apportionment.

280. Under the Massachusetts Statute, after the classes of income allocable in entirety¹ have

¹ *Supra*, paragraph 72 *et seq.*

been deducted, the remainder of the income is apportioned by means of the " allocating percentage ", which is determined as follows under Table A of the return for foreign corporations :

a) Average value (actual) of tangible property in		
1.	<u>Massachusetts *</u> =
	b) Average value (actual) of all tangible property
a) Wages, salaries, etc., assignable to Massa-		
2.	<u>chusetts *</u> =
	b) Total wages, salaries, etc.
a) Gross receipts assignable to Massachusetts *	 =
3.	<u>b) Gross receipts from all business.</u> =
4.	Total of Items 1, 2 and 3 — divide by three (3) ** =
5.	Allocating percentage (express in decimal) =

* Divide (a) by (b) to obtain decimal ; carry out decimal to at least six places.
 ** If only two of the above proportions apply, substitute (2) ; if only one of the above proportions applies, substitute (1).

Items 1, 2 and 3 are fractions and are to be reduced to decimals by dividing (a) by (b), and the result should be set down in the outer column. These decimals should then be added and an average obtained which is known as the " allocating percentage ". The instructions for computing the percentage are given below :

Item 1. — If monthly inventories have been taken, these should be used in determining the average value. For example, the total of monthly inventories divided by 12 should give the average value for the year. If monthly inventories have not been taken, inventories as of the beginning and end of the year accounted for may be used, provided the stock-in-trade and other tangible property of the corporation has remained substantially constant during the year. Distinguish between tangible property and intangible. Do not include intangible property as stocks, bonds, notes, bills receivable, goodwill and the like. Note that 1 (a) applies to tangible property in Massachusetts and (b) to all tangible property. In supporting Schedule Table A, 1, state the method which has been used.

Item 2. — Include under (a) all wages, salaries, commissions or other compensation to employees except such as is paid to employees chiefly situated at, connected with or sent out from premises for the transaction of business which are owned or rented by the corporation outside of Massachusetts. An employee is one who works for and under the control of his employer. The mode of payment, while a circumstance to be considered in determining the question of whether or not one is an employee, is not decisive. An " employee " may include a travelling salesman, even though paid upon a commission basis. It does not include an independent agent nor a contractor nor a corporation. Include under (b) all of the wages, salaries, commissions or other compensation of employees.

Item 3. — Include under (a) the following : (1) All sales except those negotiated or effected in behalf of the corporation by agents chiefly situated at, connected with or sent out from premises for the transaction of business which are owned or rented by the corporation outside of Massachusetts. Include under sales compensation for personal services. (2) Rentals or royalties from property situated, or from the use of patents, within Massachusetts. Include under (b) all sales, rentals or royalties.

Items 1, 2 and 3. — If both numerator and denominator of a fraction are “None”, the proportion is to be deemed inapplicable. If the numerator is “None” but the denominator is any amount greater than “None”, insert “None” against the item in the outer column.

For example : $\frac{0}{50,000}$ ($0 \div 50,000$) = 0. If the numerator and denominator are identical, insert 1 in the outer column.

281. The factors of real or personal tangible property, pay-roll and gross receipts are considered to reflect the extent of business activities, and hence the amount that is earned in Massachusetts. The theory underlying the Massachusetts formula is that profit results from the application of work to capital. Among factors that enter into the realisation of profits are good management of the business as a whole ; efficiency in factory management, which reduces costs and makes the margin of profit greater ; wise advertising, which facilitates the sale of the product ; and efficient salesmanship, which increases the demand therefor. Because of the fact that work is compensated by pay-roll, and as, in general, people are paid according to their worth, pay-roll may be considered to represent the compensation of work performed in any particular jurisdiction.

282. Apart from the application of work to capital, there is a yield that should flow automatically from capital, and it is therefore considered fair to include as one element in the fraction the tangible property used in the business.

283. The inclusion of gross receipts from sales as well as pay-roll may result in duplication.¹ Giving equal weight to tangible property, pay-roll and sales, irrespective of the character of the business, may attribute an unduly large amount to the sales end. The Massachusetts authorities admit that probably a distinction should be drawn between a corporation which sells a specialised product, such as a typewriter, and must expend large sums in advertising to increase its sales, and a corporation which sells a staple article which does not require any pronounced sales effort. Moreover, the place of receipt can be readily shifted. The Massachusetts authorities therefore state that the receipts factor is the most questionable contained in the formula, although it is not believed that it has caused serious distorting of results in its practical application.

284. The Massachusetts authorities further recognise that the importance of each factor varies from business to business, and that a fair tax results usually only when the factors in the formula are well balanced. Certain kinds of corporate activities do not require as much tangible property, or as much pay-roll, as others. Sometimes one factor may be disproportionate to another. Thus a corporation which manufactures and sells its product many times during the year should show a large amount of gross receipts, whereas the importance of pay-roll may be less than it would be if the turnover were not so frequent. Some corporations — for example, those rendering personal services — have very little tangible property. Other corporations, especially those dealing in real estate, or hardware or similar articles, have a substantial amount of tangible property. If the corporation produces large but valuable articles, such as railroad engines, steamships or steel bridges, and therefore only a few articles are sold, the receipts may be considerable, whereas the pay-roll may be very small. At the other extreme, there are businesses in which the other factors are preponderant, such as those engaged in the sale of women’s shoes or candy, in conducting a restaurant, a department store or even a hotel. The results of the formula may be inequitable in any such case, and, if so, the taxpayer may propose an alternative basis of assessment, such as taxation on the basis of the separate accounts of its Massachusetts branch.

¹ “Taxation of Foreign and National Enterprises”, Vol. III, page 201.

New York Methods of Fractional Apportionment.

285. Being a tax on the privilege of doing business, and not a direct tax on the local income of corporations, the allocation fraction prescribed in the New York State franchise tax is not, properly speaking, within the purview of the enquiry into the allocation methods under income-tax legislation. Furthermore, the allocation provisions¹ are so difficult to apply that the commissioner in charge of the franchise tax usually resorts to his wide discretionary powers in order to arrive at a fair assessment.

286. On the other hand, the allocation formula employed in connection with the New York personal income-tax² is of considerable interest. If the income from business carried on within and without the State which is allocable to New York cannot be taxed on the basis of a separate accounting, then an apportionment fraction may be used. As few taxpayers keep separate books clearly reflecting the income of their New York branch, the allocation formula is ordinarily employed. The Regulations describe it in the following language :

“ *Article 457.* — If the books of the taxpayer do not disclose the proportion of his net income from sources within the State of New York, his return or, if the basis of apportionment used by him shall not be approved by the Tax Commission, his amended return shall disclose his net income from business both within and without the State, and the tax will be calculated and collected upon the proportion of his total net income from business which the aggregate of the New York State factors bears to the aggregate of the total factors as herein defined. ”

The “ New York State factors ” include the following :

(1) The average of the value of his real property and tangible personal property within the State (*a*) at the beginning of the tax year and (*b*) at the end of the tax year, but only of property connected with the business ;

(2) The total wages, salaries and other personal service remuneration paid during the tax year to employees in connection with the business carried on (as defined in Article 415) within the State ;

(3) The gross sales or charges for services performed by or through an agency (of the kind enumerated in Article 415) situated within the State. The sales or charges to be allocated to New York shall include all sales negotiated or consummated by salesmen, or services performed by other representatives, attached to or sent from offices, or other agencies, situated within the State of New York.

The “ total factors ” include the following :

(1) The average of the value of all his real property and tangible personal property (*a*) at the beginning of the tax year and (*b*) at the end of the tax year, both within and without the State, but only of property connected with the business ;

(2) The total wages, salaries and other personal service remuneration paid by him during the tax year to employees connected with the business, whether within or without the State ;

(3) The gross sales or charges for services performed, whether within or without the State.

¹ *Supra*, paragraph 75. These provisions are described in detail in the Report on New York Franchise Tax on Business Corporations ; “ Taxation of Foreign and National Enterprises ”, Vol. III, pages 228 and 229.

² *Supra*, paragraphs 76 to 78.

287. It may be noted that the factors used in this formula are essentially the same as those contained in the Massachusetts formula,¹ but the fraction taken is that of the aggregate of the factors in New York to the total factors, rather than the arithmetical average of the ratios of each factor.

REQUIREMENTS FOR SELECTION OF METHODS.

288. In general, income-tax laws merely provide that the tax is upon the net income attributable to their jurisdiction, which is to be declared by the taxpayer, and give the administration full discretionary powers to resort to whatever measures are necessary to make an assessment. As any enterprise of importance keeps accounts, often in accordance with the requirements of the commercial or fiscal law of the country, it is customary for the tax authorities to require that the declaration be supported by a balance-sheet and profit-and-loss statement pertaining to the local establishment, and, in some instances, other pertinent data, including the balance-sheet and profit-and-loss statement, together with other pertinent accounts of the entire enterprise. The assessment procedure in most instances begins with an examination of the declaration and supporting accounts, and, if they are adequate and accurate enough to reflect clearly the taxable income of the local establishment of the foreign enterprise, no further enquiry will be made. In default of such accounts, they exercise their discretionary powers to arrive at an assessment on the basis of the best information available. As a rule, they first turn to that which is locally obtainable, requiring the taxpayer to reveal all its accounts and correspondence with the head office or other establishments of the parent enterprise. If necessary, the authorities resort to an estimative assessment, based on a comparison with the profits of similar enterprises, or by using the other methods previously described.² Although at liberty to do so, the authorities of most countries do not resort to fractional apportionment,³ because of the difficulties in verifying the accounts prepared at the head office or even in understanding them when they are prepared in a foreign language, in a different currency, and possibly in accordance with a different system of accounting. Such, briefly, is the average practice — complete liberty of methods of assessment, but recourse in the first instance to the declaration and separate accounts ; subject to verification and adjustment, or, if this is impossible, to the making of an assessment by employing empirical methods or the method of fractional apportionment.

289. The taxation of the local establishment on a separate basis prevails primarily in countries where the art of accounting is highly developed — for example, the British Commonwealth of Nations and the United States ; or in countries where at least the principle of territorial jurisdiction is impregnated in fiscal law — for example, France, in respect of its tax on industrial and commercial profits. Italian officials declare that they must always apply the method of a separate determination of the profits of the local establishment on the basis of accounts. Other administrations which pronounce themselves as being bound primarily to a separate determination of profits on the basis of accounts include Estonia, Latvia, Poland, Roumania, Sweden, Japan, Cuba and Mexico. Those which indicate a greater freedom of selection include British India, Canada, Belgium, Luxemburg, France, the Netherlands, Netherlands East India, Germany, Danzig, Austria, Czechoslovakia, Hungary, Bulgaria, Greece and Yugoslavia. Austria and Czechoslovakia, however, are bound by their law to apply certain minima, and the Austro-Czechoslovak and Austro-Hungarian treaties require the fractional apportionment of the joint profits of enterprises operating in the territories of the contracting States. Although the South-African administration cannot compel the submission of local accounts, and must accept the taxpayer's preference for fractional apportionment on an assets basis or for a percentage calculation in the case of shipping, cable or wireless business, these cases are

¹ *Supra*, paragraph 280.

² *Supra*, paragraph 155 *et seq.*

³ *Supra*, paragraph 173 *et seq.*

in the minority, and the majority of important businesses are taxed on the basis of satisfactory local accounts.

290. At the other extreme, the law of Spain requires that the local branch of a foreign enterprise be taxed on a percentage of total net income, determined by the relative importance of the local branch in the enterprise as a whole. In Switzerland, although not required by law or jurisprudence of the Federal Tribunal, the cantons, in practice, apply fractional apportionment in international cases as well as inter-cantonal cases.

291. Other instances where fractional apportionment is imposed as a general method of assessment are in various American States, such as Massachusetts and New York, the laws of which prescribe an allocation formula ; but, as has been pointed out, this formula may be set aside — in Massachusetts, if the taxpayer submits an acceptable alternative method, and in New York, when the Commissioner, as he ordinarily does in practice, prefers to exercise his discretionary powers of assessment. In general, the statutory formulæ of the various States may be set aside if they are shown to be arbitrary or unreasonable in a particular case.¹ Under the Income-Tax Statute of Wisconsin and the Personal Income-Tax Law of New York, the statutory apportionment formula is to be applied only when the taxpayer does not maintain satisfactory separate accounts, and even then the statutory formula may be modified or replaced by an alternative method in order to assure an equitable assessment.

RELATIVE VALUE OF VARIOUS METHODS.

292. The extent of the relative use of the different methods varies greatly from country to country. Thus, in the United States Federal administration, separate accounting, subject to adjustment, is employed in practically every case. In Spain, fractional apportionment must be applied in every case. In other countries the ratio differs greatly, but one may perhaps cite the United Kingdom as typical of countries favouring separate accounting as a basic method, in which about 55 per cent of the total cases are settled on the basis of separate accounts, possibly after some adjustment, and the percentage of turnover method in about 20 per cent of the total cases ; other conventional methods are used in the remaining 25 per cent. Although the Wisconsin authorities are inclined to favour fractional apportionment as the basic method, they estimate that separate accounting is used in about 50 per cent of the cases, the statutory formula in about 49 per cent and some alternative method in the remaining 1 per cent.

Separate Accounting.

293. A predilection for the method of separate accounting is evinced by the great majority of countries. This means that the taxpayer should submit a declaration supported by separate accounts reflecting clearly the profits of the establishment within the jurisdiction of the taxing State, resulting from its own separate activities or its joint relations with other establishments of the same enterprise. The preference for this method is declared by the following countries :

In the British Commonwealth of Nations : the United Kingdom, the Irish Free State, British India and South Africa ;

In Western Europe : Belgium, France, Italy and the Netherlands ;

In Central Europe : Germany and Danzig, Austria, Czechoslovakia and Hungary ;

In Northern Europe : Denmark and Sweden ;

In Eastern Europe : Estonia, Latvia and Poland ;

In South-Eastern Europe : Bulgaria, Greece, Roumania and Yugoslavia ;

In the Orient : Japan ;

In Latin America : Cuba and Mexico ;

In the United States of America : the Federal Government.

¹ *Supra*, paragraphs 92 and 97.

Among the American States, the Wisconsin authorities prefer it wherever possible, and the New York State personal income-tax officials regards it as the most practical and satisfactory.

294. The authorities of all these States, however, stress the necessity of verification, and of recourse to other methods of assessment when the accounting is insufficient. In other words, the burden is upon the taxpayer to keep its accounts and to carry on intra-establishment transactions in such a way as to effect a fair allocation to the establishment which is being subjected to taxation.

295. Some of the pronouncements in favour of separate accounting follow :

“ The separate accounting method is considered to be the most satisfactory. Where there are no interlocking transactions between the main enterprise and the branch establishment, no difficulty is experienced in determining the profits from the accounts. Where there are interlocking transactions, it is necessary to have a clear understanding of the course of business between the head office and branch and to know the basis adopted in transactions between them (*e.g.*, on what basis goods have been invoiced between them, how head-office expenses have been allocated, etc.). Given this information, it is usually possible for the authorities and the taxpayer to reach agreement as to the treatment of these transactions, and the profits can then be satisfactorily ascertained from the accounts ” ¹ (United Kingdom).

296. A statement of similar import was made by the authorities of the Irish Free State.

297. “ The method of separate accounting is considered the best if the accounts truly reflect the British Indian income, but it is not usually sufficient, as the transactions of the head office and branches are generally so closely interlocked that it is difficult to isolate the British Indian income. Furthermore, the transactions between the head office and branches require a very close scrutiny, which entails the examination of the head-office accounts.” ²

298. “ Every encouragement is given to the submission of local accounts, which are considered the most satisfactory basis for securing a fair assessment. In so far as such an account deals only with transactions completed in the Union, it will give a true reflection of the income from Union sources, and the wide discretionary powers given to the administration in the allowance of expenditure incurred outside the Union makes it difficult for claims for such expenditure to be used as a means of evasion. If the claim is suspect, it can be disallowed, and, so long as the Commissioner has exercised his discretion fairly and honestly, it cannot be reviewed ” ³ (South Africa).

299. “ The most practical and satisfactory method is taxation in accordance with accounts susceptible of being verified by the administration ” ⁴ (Belgium).

300. “ The profits should, in principle, be determined on the basis of the signed declaration and with the help of the separate accounts of the French establishment ” ⁵ (France).

301. “ The method of independent determination is the best for fixing the income of an Italian branch or subsidiary of a foreign company, because this method conforms to the fundamental principle of the territoriality of the income, its purpose being to ascertain the exact figure of income realised

¹ “ Taxation of Foreign and National Enterprises ” Vol. I, pages 192 and 193

² *Ibid.*, Vol. III, page 37, paragraph 102.

³ *Ibid.*, Vol. III, page 184, paragraph 87.

⁴ *Ibid.*, Vol. II, page 81.

⁵ *Ibid.*, Vol. I, page 80.

in the Kingdom. It therefore obviates having to establish the total income that the enterprise realises as the result of its various activities in different States. The determination of total income is difficult, but it is less difficult than apportioning it between the head office and the various branches or subsidiaries " ¹ (Italy).

302. The most satisfactory method is that of separate accounting. Empirical or arbitrary methods have only one advantage — their simplicity. As for the method of fractional apportionment, it appears adequate for financial and banking enterprises and insurance companies, especially where the last-mentioned have in the Netherlands an important branch and not a mere agency. ² (Netherlands).

303. " Generally speaking, it may be stated that, for the great agricultural and mining concerns, it is possible to arrange their book-keeping in Netherlands East India in such a way that the figures give a clear idea of the financial result. At the same time, it will be necessary to verify the branch accounts in the light of annual accounts, sales bills and compensation accounts of the head office and, as a rule, this can easily be done. The export and import concerns present the real difficulties, and there is a growing tendency to fix the East-Indian profit at a certain portion of the total result " ³ (Netherlands East India).

304. " Theoretically, the method of separate accounts would be perfectly satisfactory, if only these accounts gave a true picture of the results of operations in Austria. In many cases, however, experience shows that these accounts are submitted in such an arbitrary form that the whole method loses much of its value " ⁴ (Austria).

305. The advantages of determining separately the income of a local branch in the light of its particular circumstances are recognised, but this method is subject to inherent difficulties — the technical difficulty of examining all the pertinent facts in a complicated business organisation, of erroneous accounting practices, of differences in legislation at home and abroad ⁵ (Czechoslovakia).

306. " From the viewpoint of normal use and prevention of tax evasion, the method of separate accounting is considered to be the most satisfactory. Although it is not easy for the administration to check the accounts where there are interlocking transactions, most of the difficulties can be overcome by a clear understanding of the course of the business and a study of the internal accounting method " ⁶ (Japan).

307. " The method of separate accounting is the one intended by the law and is always employed unless the insufficiency of the declaration and accounts of the taxpayer force the assessment board to resort to an empirical assessment " ⁷ (Mexico).

308. " The method of separate accounting, subject to verification, is the preferred method " ⁸ (United States).

309. " The first method, that of complete and separate sets of accounts for the branch and

¹ " Taxation of Foreign and National Enterprises ", Vol. II, page 36.

² *Ibid.*, Vol. II, page 366.

³ *Ibid.*, Vol. III, page 151, paragraph 90.

⁴ *Ibid.*, Vol. II, page 30.

⁵ *Ibid.*, Vol. II, pages 115 and 116.

⁶ *Ibid.*, Vol. III, page 94, paragraph 106.

⁷ *Ibid.*, Vol. III, page 122, paragraph 80.

⁸ *Ibid.*, Vol. I, page 250.

main offices, with proper adjustments for intercompany transactions, is the most practical and most satisfactory from the standpoint of the State. Probably no other method can reflect the income earned within the State so accurately”¹ (New York State Personal Income-Tax).

310. “It is our experience that an acceptable method of separate accounting is possible only in a limited number of types of business. The following represent the principal types to which it has been found to be adaptable : trading companies ; construction companies ; manufacturing companies manufacturing a complete product and maintaining a separate sales organisation therefor within the State.

“Trading companies can usually report on a separate basis, because the scope of their activity is usually limited to the trading area adjacent to the location of the establishment. Usually, the only items of apportionment will be the purchase department expenses, if the purchases are made by a central purchasing agent ; allocation of some administrative overhead expense ; and perhaps some nominal accounts such as Federal income-tax payments and interest payments on general loans incurred on behalf of more than one establishment. The operating results of a trading concern are very closely dependent upon the character of the population, the buying habits and resources of the particular territory served, and for this reason a separate accounting tends more accurately to reflect the true conditions as regards the profits earned.

“A construction company engaged in construction projects such as buildings, dams, concrete roads and bridges, sewers, etc., almost invariably keeps accurate job and construction cost records for each project or undertaking, and, with the exception of a few general items of administrative overhead, the costs are applied directly and the profits of each are determined separately from the other. This situation is ideal for a separate accounting. It also reflects a more accurate picture of the profits realised than a general apportionment, since the latter tends to average the profits over all the projects performed, whereas construction business by its very nature is such that large variations in profits between different projects will and do occur.

“We also find certain instances of manufacturing concerns which maintain a complete and integrated organisation, incorporating all elements of an independent concern — that is, owning and employing their own property, performing all of their own manufacturing or assembling operations, maintaining their own sales organisation, doing their own financing, and keeping separate and distinct books of account. A few instances of this do occur within this State where the establishment is a branch or subsidiary of a larger company employed in the same general line of business, and when such branch or subsidiary is conducted and operated as a distinct and self-sustaining unit it will lend itself to an accurate separate accounting”² (Wisconsin).

Empirical Methods.

311. Broadly speaking, empirical methods cannot be considered as primary methods of assessment, but only as measures which are resorted to when the accounts pertaining to the local establishment are insufficient, or when no such accounts are maintained at all. Although fractional apportionment might be considered an empirical method, it is treated separately below because of its being the primary method of assessment in Spain, Switzerland and many of the States in the United States.

312. The empirical methods have been previously described in detail,³ and, although they are fairly numerous and varied in nature, the one method for which a general preference is expressed is the percentage of turnover method. The relative merits of certain empirical methods and the

¹ “Taxation of Foreign and National Enterprises”, Vol. III, page 220.

² *Ibid.*, Vol. III, pages 245 and 246.

³ *Supra*, paragraph 155 *et seq.*

feeling on the part of many administrations that they should not be resorted to except when separate accounting fails, because of their arbitrary character, is evidenced by the following statements.

313. "Where agreement cannot be reached and the separate accounting method fails, the 'percentage of turnover' method is most frequently adopted. This, it is suggested, is the most convenient alternative method for manufacturing and merchanting businesses, where a 'turnover' test, taking one year with another, is likely to give fairly satisfactory results.

"Where the separate accounting method has failed and the 'turnover' method cannot be applied owing to the nature of the business (*e.g.*, banks, insurance companies, etc.), the best available method for the particular industry is followed (*e.g.*, an assets basis for banks, a premium basis for insurance companies, a train-mileage basis for railways, a freight basis for shipping, etc.). In the absence of any better evidence, these are likely to give fairly satisfactory results, taking one year with another, and it is certainly an advantage to have some definite method agreed between the taxpayer and the revenue authorities" ¹ (United Kingdom).

314. A statement of similar import was made by authorities of the Irish Free State.

315. "The percentage of turnover method and the method of fractional apportionment (which consists in apportioning total net profit in the ratio of receipts in India to total receipts) are those most commonly employed, and, of the two, the fractional method is usually preferred by the Crown and the taxpayer as being less arbitrary and giving a closer estimate of the true profits.

"The use of the fractional method is ordinarily limited to cases where the chain of transactions is completed in British India — for example, where goods have been manufactured or purchased abroad and sold in India. It is not considered possible to apply this method where the chain of transactions merely begins in British India, such as where goods are purchased there and exported for sale abroad; in such instances, it is customary to apply a percentage to the receipts from the sale of goods exported, which is intended roughly to represent the profit which the foreign enterprise makes by operating itself instead of buying through agents or brokers.

"The method of estimating income is a reserve power to be used at the discretion of the income-tax officer, and this method is seldom applied by itself. For example, it is resorted to when the use of the fractional method without further adjustment would give unfair results" ² (India).

316. If separate accounting fails, the most practical of the other methods seems to be that of determining the profit on the basis of turnover, either by applying to the turnover of the local establishment of the French enterprise the average percentage of net profit made by similar enterprises, or by multiplying such turnover by the coefficient of gross profit of similar enterprises and subtracting therefrom the overhead charges of the local establishment. There is then no need of examining the accounts of the foreign enterprise. The selection of a method is essentially a question to be determined by the facts of the case. A method which seems satisfactory in one case may prove defective in another ³ (France).

317. "A method satisfactory for all cases does not exist. The decision must be taken by the competent authorities on the basis of the facts of each case, having regard to what is fair and right, with the result that certain general principles will gradually be evolved for settling cases of the same or similar nature." The method of assessing a profit equal to that of analogous independent

¹ "Taxation of Foreign and National Enterprises", Vol. I, page 193.

² *Ibid.*, Vol. III, pages 37 and 38, paragraphs 102 to 104.

³ *Ibid.*, Vol. I, page 80.

German undertakings, or to the normal rate of interest on the capital invested, also achieves reasonable results ¹ (Germany).

318. If separate accounting is insufficient, the Greek authorities prefer the percentage of turnover method, as the latter, like the former, requires looking only into data locally obtainable, the results thereby being free from the influence of conditions of foreign establishments. Fractional apportionment is used only as a last resort ² (Greece).

319. If the method of separate accounting "is unsatisfactory in the case of the business of buying and selling or of producing and selling, the percentage of turnover method is considered more practical as an alternative than the fractional method, because the check on the facts on which it is based can be made within the country wherein the taxable income arises; and there is, furthermore, less likelihood of error in the facts themselves and difficulty in analysing them. This method may not be technically free from error, but for the classes of business to which it applies (*i.e.*, industrial and mercantile) it forms a reasonable substitute for fair invoicing and the keeping of inventory and for a proper accounting in respect of the related business to which they apply.

"In general, it is believed that fractional and empirical methods should be used only as a last resort, as in some instances they tend to spread inequalities on an even basis, whereas such inequalities should be localised and remedied through the proper keeping of accounts. In other instances, they distort or throw profits where they do not belong under actual economic circumstances" ³ (United States).

320. With regard to the taxation imposed on income by the various States in the United States, empirical or arbitrary methods used approximately to determine profits are considered unsatisfactory and have been condemned by the courts. ⁴ Thus, in Wisconsin, the income of a branch may be determined on the basis of a percentage of turnover, but it would only be used as a last resort due to lack of records. In case a company doing business in Wisconsin refuses to file a tax return, the company is assessed on an estimated income, called a "doomage" assessment, which is generally so high that the company finds it advantageous subsequently to file the required return. Similarly, the authorities enforcing the New York State personal income-tax resort to an empirical method only when there is no other method of arriving at the income of the branch.

321. "The empirical method is the least satisfactory, for the reason that, to arrive at a percentage to apply against sales or against bank deposits, etc., it is necessary to have more or less accurate comparisons of the business of several other individuals in the same kind of business and doing business under similar conditions. This is difficult, because the statistics on the returns of one year cannot ordinarily be established until the following year. Even then the taxpayer in question, through poor management or owing to peculiar conditions existing in his business, may have sustained losses where all the others with whom comparison is made have realised gains and profits" ⁵ (New York).

322. Because of the wide discretion given the Massachusetts and New York authorities in administering respectively the excise-tax and the franchise-tax on business corporations, and the

¹ "Taxation of Foreign and National Enterprises", Vol. I, page 119.

² *Ibid.*, Vol. II, page 184.

³ *Ibid.*, Vol. I, page 250.

⁴ *In re U. S. Metal Goods Co.*, 1924, 4 F. (2d), 871 (N. D. Ohio); *in re Sheinman*, 1926, 14 F. (2d), 323 (E. D. Pa.).

⁵ "Taxation of Foreign and National Enterprises", Vol. III, page 220.

minimum taxes prescribed by its laws, there is no occasion to resort to empirical assessments as understood in connection with the income-taxes previously discussed.

Fractional Apportionment.

323. The one country in which fractional apportionment is the sole method of assessing a foreign enterprise with a local establishment is Spain ; but, if the Spanish establishment is practically autonomous, the income shown in its regularly-kept books is usually taken as the basis for taxation, even though the jury computes the percentage which this amount bears to the total income and formally makes the assessment in accordance therewith. It was because most branches of foreign enterprises were not conducted as " autonomous " establishments, but were so managed that little or no profit appeared in their books, that the Spanish Government abandoned the method of assessment on the basis of a book-keeping in 1920 and introduced the requirements for fractional apportionment. The numerous arguments presented by the Spanish report in favour of the system of fractional apportionment may be summed up as follows :

(a) It is the only system which assures that enterprises will be taxed according to their real capacity to pay and consequently precludes the overlapping of assessments, resulting in the taxation of more than 100 per cent of the income ;

(b) This system is the only one which permits the taxation of the branch or subsidiary in accordance with its real importance in the enterprise as a whole.

324. The method of fractional apportionment has been well tested in Switzerland, especially in relations between cantons, and the following arguments are presented in its favour : It spares the fiscal authorities the rectifications of separate accounts with the subsequent contesting of assessments by the taxpayer ; it permits a complete taxation without excessive levies or evasion ; it realises in the fullest extent possible the ideal of fiscal justice. It does not encounter in Switzerland the opposition of foreign enterprises having establishments in the country, as one would be tempted to believe. Although, through application of that method, the income of a profitable establishment in Switzerland, belonging to a less prosperous foreign enterprise, may be taxed in Switzerland only partially or not at all, one may not infer that apportioning the profit favours foreign competition to the detriment of national enterprises ; instead, the fractional apportionment of the profit rather avoids such a consequence, save for exceptional cases which are perhaps encountered less frequently under the regime of another method ¹ (Switzerland).

325. Despite the fact that the South-African law prescribes fractional apportionment in the ratio of assets subject to being supplanted by assessment on the basis of satisfactory accounts, the authorities make the following observation : " Any basis of apportionment must produce a rough-and-ready result, and an apportionment on the basis of assets must be inadequate in the case of a business whose earnings bear little or no relation to the local situation of its assets. Moreover, that local situation raises questions of difficulty in connection with movables, such as stock-in-trade and cash assets. In every way a basis of apportionment is to be deprecated unless no other method of assessment is practicable " ² (South Africa).

326. Although Austria and Hungary are satisfied with the system of fractional apportionment contained in their treaty regime, the Czechoslovak report, after pointing out the difficulties inherent in separate accounting, refers to the Austro-Czechoslovak treaty in substantially the following language : It would seem that the method of taxing an agreed fraction, as in the Austro-Czechoslovak

¹ " Taxation of Foreign and National Enterprises ", Vol. II, page 452.

² *Ibid.*, Vol. III, page 184, paragraph 87.

treaty, would obviate to a large extent these difficulties. Experience has shown, however, that such a method does not prevent double taxation, because the laws of the two countries differ in their allowable deductions. As each State verifies the total profits according to its own law, long negotiations must precede the fixing of the apportionable total income ; otherwise, each State would apply its fraction to a different total and there would be double taxation to a certain degree. Moreover, under this system, a branch might, in fact, realise a loss, yet it would nevertheless be taxable. ¹

327. The report of Netherlands East India evidences an inclination to turn to the fractional apportionment of the joint profits of the establishment of a foreign enterprise which purchases without and sells within, or manufactures without and sells within, that country, and also in the case of other enterprises which do not maintain accounts which clearly reflect the profits of the local establishment. ²

328. Whereas the United States Federal Government uses fractional apportionment as a primary method only in case of life-insurance companies and transport enterprises not subject to the regime of reciprocal exemption, it has recourse to fractional apportionment in the case of industrial and mercantile enterprises, as authorised by the Regulations, only when no independent factory price can be determined, or when the taxpayer does not produce regularly-kept books of account which show a fairer allocation of profit than that which can be effected by the prescribed formula.

329. The Wisconsin authorities explain their frequent use of fractional apportionment by the fact that most of the important foreign corporations are engaged in some form of manufacturing or processing, and only a part of the whole business organisation is maintained in Wisconsin, the balance being situated outside the State. For example, the manufacturing or assembling unit may be located in Wisconsin, but the general office and sales organisation, together with other manufacturing units, are located entirely without the State, or, on the other hand, a selling agency or branch may be all that is located in Wisconsin, while the rest of the activities are located without the State. In other cases, it may occur that only a storage warehouse, either owned or leased, is located in Wisconsin with no sales department or any agency attached thereto. The Wisconsin report raises the question : How can one determine on a separate accounting basis the profits of one or a number of manufacturing or assembling units independently of the rest of the business, especially when the product is only partially manufactured or assembled in Wisconsin and then transferred outside the State for completion and sale ? Or, again, if a selling agency is all that is located within Wisconsin, how can its profit be accurately determined on a separate accounting basis when the product is such that no definite market price or transfer price from the factory to the selling agency can be determined ? Or, if the only activity is a storage warehouse within Wisconsin, used for convenience in filling orders, on what basis can the profits arising from the use of this storehouse be accounted for separately ? It has been found impracticable, if not impossible, to account separately for any single activity or phase of an interrelated business structure, and in this case only one method has been found practicable, and that is to take a percentage of the total ultimate net profits realised, such percentage to be determined by an analysis of the principal elements of the business. Under the Statutes of Wisconsin, the basic elements of a manufacturing business consist in the tangible property employed in the business, the cost of manufacture and the sales. Whether these three elements should be given equal weight as in the Wisconsin formula or whether relatively different weights should be given them is a matter of opinion. The experience of the Wisconsin officials has been that the use of their method has proved very satisfactory, and

¹ " Taxation of Foreign and National Enterprises ", Vol. II, page 116.

² *Ibid.*, Vol. III, page 151, paragraphs 89 and 90.

they state that many leading manufacturers employing it have expressed their approval and satisfaction in the results thereof. ¹

330. The authorities in charge of the New York State personal income-tax declare that " the fractional method, while practical and used in the majority of cases under the New York law, is faulty and can only be an approximation, which does not always do justice either to the taxpayer or to the State ". ²

331. The Massachusetts authorities are bound to apply the allocation formula, unless the foreign corporation proposes an alternative method which reflects more clearly the income earned in Massachusetts, or unless the corporation objects to the allocation formula and the Commissioner determines the tax by some other method which he considers equitable in the light of the particular facts. Probably the only cases where separate accounting has been requested have been in connection with the maintenance of a sales organisation in Massachusetts, the manufacturing activities being entirely outside that State. In such cases, the question arises as to what is the actual profit derived as the result of the sale of goods consummated in Massachusetts. This usually involves a question of the division of the profits resulting from those sales as between the producing activities and the sales activities. Where it can be established that goods are billed to a branch or subsidiary corporation at actual manufacturing cost, and the expense of maintenance of the branch has absorbed all of the difference between the price at which the goods are billed to the branch and the sales price, it would seem that there can be little or no question of division. If goods are billed to the branch at a price in excess of manufacturing cost, difference in opinion is more than likely to arise. If the article is a staple product, market conditions and quotations can be resorted to as a test of the fairness of the price charged to the branch office ; but in these days, when many articles are distinctive, bearing a trade mark or trade name, the market conditions are not available, for there is no other article of precisely the same brand. In such cases, a more or less arbitrary apportionment of the gross profit between manufacturing cost and selling price by the branch office must be effected. In very few instances, adjustments have been made on the basis of apportioning to the producing end two-thirds of the profit, and to the sales end one-third, but this can by no means be fairly laid down as a rule for general application. A comparison of expenditure might be helpful in making a fair apportionment. Very few cases in Massachusetts, however, have been settled on the basis of separate accounting, and no case is recalled where any reference to expenditure has been resorted to. The Massachusetts report emphasises the fact that the tax on corporations is an excise and not a pure income tax, and that in its conception the Legislature intended to levy a fair tax on business activities in Massachusetts and to measure the extent of these activities, whether they were profitable or not. ³

COUNTRIES WITH NO PREFERENCE.

332. To present a true picture of the situation, it should be mentioned that a few countries are very doubtful as to which method is preferable as a general rule. Most administrations recognise that, even if the method of separate accounting is adopted, it may be necessary to resort to fractional apportionment in respect of certain items of income or in prorating general overhead, interest on general indebtedness, and possibly other items of expenditure. It is felt, in general, that the authorities must have freedom to fit the method to the case, in view of the great differences in the organisation and circumstances pertaining to each particular business. This attitude is quite pronounced in the reports of Canada, Germany, Hungary and Netherlands East India. ⁴

¹ " Taxation of Foreign and National Enterprises ", Vol. III, pages 245 and 246.

² *Ibid.*, Vol. III, page 220

³ *Ibid.*, Vol. III, pages 201 to 203.

⁴ *Ibid.*, for Canada, see Vol. III, page 66 ; for Germany, Vol. I, page 119 ; for Hungary, Vol. II, page 220 ; and for Netherlands East India, Vol. III, page 151, paragraphs 89 and 90.

CHAPTER V.**FOREIGN ENTERPRISE WITH LOCAL BRANCH — ALLOCATION CRITERIA.****INTRODUCTION.**

333. The general concept of taxable net income being the difference between gross income and allowable expenses incurred in earning such income, one of the principal problems of allocation is presented when the income arises in one country, whereas some of the incidental expenses are incurred in another country. Should income be allocated to the place of expense in order to cover it, or should expense be allocated to the establishment where the income arises and is entered in its books? Some items of income and expense are definitely allocable to a certain establishment, but there is generally a large residuum of items of income and expense which are not definitely allocable, and it is these items of income and expense that present the most difficult problems in allocation.

334. With regard to income, this category includes primarily income derived partly from sources within one country and partly from sources within another — for example, income derived from the manufacture of goods in one country and their sale in another. In general, when business is carried on through permanent establishments, it is easy enough to ascertain the establishment at which the income arises and accrues, but the problem remains to determine how much of the income should be allocated or apportioned to establishments in other countries which conduce to the earning of the income.

335. Most items of expense are definitely allocable — for example, rents, cost of maintenance, electric lighting, salaries paid to local employees, and the numerous other expenditures incidental to operating an establishment of any kind.

336. The principal category of not definitely allocable expenditure is that incurred at the real centre of management of the enterprise which benefits the enterprise as a whole, such as interest paid on borrowed capital which is used throughout the enterprise, including establishments in other countries, and items of general overhead, such as salaries of directors and officers charged with the general administration of the business, the expense of a central staff of accountants or other technical experts, and sometimes the expense of a general advertising campaign conducted at the real centre of management. Should any profit be ascribed to the activities of general management as such, or the other indicated activities which take place at the real centre of management? If the real centre of management is situated at the factory or principal establishment of an enterprise, this question loses its significance to a large extent, because of these expenses, together with the other expenses of the principal establishment, being covered by the profits attributable to the principal establishment. If the enterprise manufactures at its principal establishment and sells from it to independent dealers in other countries, or invoices goods at an independent factory price to its own

sales establishments in other countries, a proportionate part of these general overhead expenses should be included in the invoice price. The principal categories of taxpayers, in which claims are made for allocating a part of the general overhead expenses to the real centre of management abroad to local branches, are banks and insurance companies, which have their head office or their principal banking establishment in one country, but important branches in other countries.

337. It not infrequently arises that an enterprise will have in one country only its real centre of management, and in other countries its mines, plantations, factories, purchase and/or sales offices, railways, or other productive establishments. Cases of this nature frequently occur in countries with colonies or dominions beyond the seas. For example, there are many enterprises with their real centre of management in London, and all their productive establishments in one or more of the dominions or colonies in the British Commonwealth of Nations. Most of the enterprises operating in the Belgian Congo have their head offices in Brussels or Antwerp. Similarly, the wealth of the French Colonial Empire is being exploited, to a large extent, by French *sociétés anonymes* with their seat in Paris. The plantations and mines of Netherlands East India belong almost exclusively to Dutch companies which hold their directors' meetings at their head offices in Amsterdam or The Hague.

338. Very few of these enterprises realise profits at their head offices, which, however, involve considerable expense. To-day the United Kingdom allocates the whole of the profit of the "central management and control" in London, allowing the deduction of expenses incurred abroad and taxes paid there, and other countries assure themselves a revenue from such offices in accordance with the same or other precepts or methods of taxation. For the purpose of solving the problem of allocation, however, it is necessary to decide whether a percentage of the gross or net income should be ascribed to the real centre of management as such, or whether its cost should be apportioned to the various establishments in other countries.

ALLOCATION OF PROFIT TO REAL CENTRE OF MANAGEMENT.

339. The great majority of countries, when taxing on the basis of the separate accounting of the local establishment, do not permit any part of the profit attributable to the local establishment to be excluded from the assessment for the purpose of allocating it to the real centre of management¹ in another country. On the contrary, they allow, in principle, a reasonable proportion of interest on general indebtedness and general overhead to be deducted from the gross income of the local branch. The only countries which allot income to the real centre of management abroad are Spain and Switzerland under their respective systems of fractional apportionment, and Austria and Hungary with regard to companies subject to their allocation agreement.² Other countries indicate that, when resorting to fractional apportionment, a part of the net income may be thrown to the head office, but the intent is to throw a part of the total net income revealed in the accounts of the head office to the local establishment, rather than to compensate management as such.

¹ The term "real centre of management" was employed in the model Conventions drafted by the General Meeting of Governmental Experts, Geneva, 1928 (document C.562.M.178.1928.II), to denote the fiscal domicile of an enterprise. It corresponds to "central management and control" in United Kingdom law and to similar phrases in other laws which describe the place where the corporation has its actual seat of direction, as contrasted with its formal statutory seat or head office. In general, it coincides with the statutory seat (*siège social*) of the company, but if the real centre of management is in a different country, it is the intent of the model Conventions that the latter should be considered the enterprise's domicile for tax purposes. The concept "real centre of management" is not known in the laws of many countries (e.g., United States of America, Mexico).

² The Swedish communal tax law provides for the allocation of 5 per cent of the net profit to the real centre of management, and this principle may be applied in connection with the State income tax.

340. The countries which tax the foreign enterprise on the full profits attributable to the local establishment, without ascribing any profits to the real centre of management as such, include those countries which apply separate accounting as a primary method of taxation — namely, the United Kingdom, the Irish Free State, British India, Canada, South Africa, Belgium, Luxembourg, France, Italy, the Netherlands, Netherlands East India, Denmark, Germany, Danzig, Czechoslovakia, Hungary, Estonia, Latvia, Poland, Bulgaria, Greece, Yugoslavia, Roumania, Japan, Cuba, Mexico and the United States. When taxing the foreign enterprise on the basis of its separate accounts, Wisconsin makes no such allowance, but the New York State personal income-tax authorities declare that they sometimes attempt to ascribe a certain portion of locally realised profits to the real centre of management in another State, if it appears that New York is being attributed more than its fair share of the income of the non-resident.

341. The British Indian authorities state that no part of the profit of the local branch will be attributed to the head office abroad merely because the management is located there, whether the local enterprise is taxed on the basis of its separate accounting or by applying the fractional or percentage of turnover methods. The Netherlands East Indian administration expresses the same viewpoint, contending that the mere fact of the management of a business being situated abroad, whereas the business itself is carried on entirely in Netherlands East India, cannot be considered of sufficient importance to justify holding that a part of the profits have been made in the former country. This attitude is due to the fact that the enterprises in Netherlands East India are primarily engaged in mining and agriculture, having on their own estates factories which turn the raw material into products saleable on the international markets. World market prices exist for staple products, such as sugar, tea, coffee, pepper, copra, tin and rubber, and many of these products are sold by tender or sealed bids at an exchange or place of auction.¹ Consequently, the work of the directors with regard to selling is of very little importance in the making of profits. In other instances, the management performs services to which a part of the profits may be attributed; but, in principle, no special part of the profits is to be apportioned to the management because of its function. Practice will surely reveal, with regard to many concerns, that it is impossible to keep strictly separate the management as such, and its task in regard to profit-making. In any event, it must not be overlooked that the fact of a corporation being organised in a certain country and having its head office there is often of a purely formal nature.²

342. The Austrian law does not recognise any *Sitzquote* to be ascribed to the centre of management abroad of a foreign enterprise, although, in the case of an Austrian enterprise with branches abroad, a minimum percentage of total net income (not merely joint income) must be ascribed to the seat in Austria because it enjoys the same protection and advantages as an enterprise operating exclusively in Austria. This minimum percentage is one-fourth for individuals and partnerships subject to the general profits tax (*allgemeine Erwerbsteuer*) and one-tenth for companies subject to the company tax (*Körperschaftsteuer*). There is likewise no provision in the treaties to prevent double taxation, which Austria has concluded with the other European countries, for allocating a *Sitzquote* to the real centre of management of a foreign enterprise, except in the treaty

¹ For example, tobacco produced in Northern Sumatra is sold in the following manner: samples are exhibited at an auction place, called Frascati, in Amsterdam. Buyers from all over the world examine the samples and submit sealed bids for certain lots. At a given time, the bids are opened and the lot is sold to the highest bidder. Tea is sold on the local Batavia market and also at auction in Amsterdam. Sugar is sold entirely by a selling organisation of sugar-growers called the United Java Sugar Producers, in Soerabaia, which fixes the price. Most of the rubber is sold on the exchanges at London and Amsterdam. Coffee is sold on the local markets in Batavia and Soerabaia or on the exchanges, especially in London and Amsterdam. The price of pepper and copra is largely fixed by the market in New York or London. The special market for coffee is Amsterdam. The price of tin produced by private companies depends primarily on the London market.

² "Taxation of Foreign and National Enterprises", Vol. III, page 35, paragraphs 91 and 92.

with Hungary which reserves a minimum fraction of one-tenth of total net profits to the State in which the company has its seat.

343. On the grounds of nationality, the Spanish law requires that a Spanish company be taxed on at least one-third of its profits, and, in conformity with the principle of fundamental equality between foreign enterprises operating in Spain and Spanish enterprises, the practice is to attribute a proportion of the profits of the foreign enterprise to its real centre of management abroad. The jury of experts fixes the ratio assigned to the head office, considering the importance of the management in the business. If the management exercises not more than a certain control, the local branch being under its own management and in a large measure autonomous, the ratio is about 10 per cent of the net profits. This ratio is increased in the measure that the central management becomes more important, reaching nearly one-half of the total net profit when the business is such that its success depends in all essentials upon the efficiency of the management. Thus, in the case of a foreign enterprise producing and selling famous brands of sherry, the proportion attributed to the head office exceeds 40 per cent of the profits.

344. In Switzerland, it is recognised that the influence which the direction and central administration exercise in the production of profits is insufficiently expressed in the productive factors used in the allocation fraction, and, in order to take this influence into account, the jurisprudence of the Federal Tribunal authorises the canton of the seat to impose a *préciput* of profits which varies from 10 to 25 per cent. The percentage depends on the circumstances, notably the part of the direction and central administration in the management of the business and the measure in which it contributes to the formation of the profit. It may be recalled that, in the example previously given of the Swiss method of fractional apportionment, ¹ a *préciput* of 15 per cent is attributed to the canton in which is situated the commercial direction and a *préciput* of 5 per cent to the canton in which is situated the technical direction. After deducting the 15 plus 5, or 20 per cent, from the total net profit, the balance is apportioned in the ratio of the productive factors.

345. When applying their allocation fractions, Wisconsin, New York and Massachusetts take no account of the importance of the head office itself, although the application of the formula may incidentally throw a certain proportion of profits to the head office.

APPORTIONMENT OF EXPENSES OF REAL CENTRE OF MANAGEMENT.

346. As a corollary of not allowing an apportionment of gross profit to the real centre of management, the majority of countries, when taxing the local branch of a foreign enterprise separately on the basis of its accounts, allow a certain part of interest on general indebtedness and of general overhead of the real centre of management abroad to be deducted from the gross profits of the local branch. Where the fractional apportionment of total net income is practised, as in Spain and Switzerland, there is no question of apportioning separately these items, as they are first deducted from gross income in computing the net income which is divided on a percentage basis. Nevertheless, the Wisconsin authorities state that, if the local branch is engaged in manufacturing, collecting, assembling or processing, a part of the overhead assignable to the activities within Wisconsin may first be computed in order to serve as a factor in the allocation fraction.

347. The one country which has a definite provision in its law and regulations concerning this allocation is the United States. It may be recalled that the United States system provides, first,

¹ *Supra*, paragraph 229.

for an allocation of gross income to sources within the United States and sources without the United States ; secondly, the allocation of expenses, losses and other deductions which can properly be apportioned or allocated to items of gross income from sources within the United States and from sources without the United States ; and, thirdly, for the apportionment to each category of a rateable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income.¹ This rateable part is determined by the ratio of gross income from sources within the United States to the total gross income.²

348. In other countries, the practices in regard to interest on general indebtedness and to general overhead are so different and the requirements for making the allowance so varied that these deductions will be discussed separately below.

Interest on General Indebtedness.

349. The countries which, in principle, allow, when taxing on the basis of a separate accounting, an apportionment of a reasonable part of the interest on general indebtedness to the local establishment include : British India, Canada, South Africa, France, Luxemburg, Netherlands East India, Denmark, Sweden, Germany, Danzig, Czechoslovakia, Hungary, Poland, Greece, Japan, Cuba, Mexico, the United States (Wisconsin and New York). The conditions and circumstances under which this apportionment is allowed vary from country to country, and the basis on which it is effected also varies from country to country.

350. Thus, British India would first allocate the items of interest to the principal profit-earning transaction or group of transactions, to which they can be correlated, and would apportion the balance, the usual basis of distribution being that of turnover — *e.g.*, in the case of banks, the volume of loans granted by the local branch to the total volume. Canada conditions the allowance upon a close relationship of the loan to the activities in Canada. Under South-African law, if the enterprise as a whole has a general debt, whether secured or unsecured, which has been incurred for the purposes of the whole enterprise, a proportionate part of the interest paid is admitted as a charge against the branch profits. The proportion to be so allowed is determined on different principles, according as the indebtedness is or is not secured by a debenture issue. In the event of there being a debenture issue, secured by a bond on the assets of the enterprise as a whole, the apportionment is made on an assets basis, as in such a case the indebtedness is definitely linked to the assets of the business ; the amount of interest to be allowed against the Union branch is then determined by the proportion of the assets located in the Union. In the case of an unsecured indebtedness, the amount of interest charged out in the accounts of the branch is scrutinised in relation to the relative volume of the branch operations, and its acceptance as an allowable deduction depends on the reasonableness of the claim.

351. In computing the French tax on industrial and commercial profits, there may be deducted from the gross income of the local establishment the whole of the interest on a debt contracted exclusively for the operation of the establishment, and that part of the interest on general indebtedness which corresponds to the fraction of the loan regarded as being especially used for the operation of the local establishment. In Luxemburg, an estimate is made of the deductible part of the interest. The principle adopted by Netherlands East India is essentially the same as that of France. If a foreign enterprise has its real centre of management in, for example, the Netherlands, but its entire business in the East Indies, the total interest on the loan would be charged to the profits taxable in the latter country ; but if, for example, an English rubber company

¹ Revenue Act of 1932, Section 119.

² Regulations 77, Article 68o.

operates exclusively in Sumatra and then decides to open rubber estates in Liberia and negotiates a loan for that purpose, the interest on the loan will not be charged against the East-Indian profits. If a foreign enterprise has sales branches in Netherlands East India and other countries, it is almost impossible to assign loans to a particular branch, and, provided an apportionment has not been effected in the invoice price, the interest may be divided in accordance with the importance of the branch in the business complex, which can as a rule be represented by the ratio of its turnover to that of the enterprise.

352. The Danish allowance is generally in the ratio of the gross value of the assets of the real centre of management and those of the branch. Germany and Danzig allow deduction of the interest charged which is economically connected with the income of the German establishment, and, if there is no such economic connection, the interest may be distributed on a reasonable basis — for example, in proportion to the gross income or to the assets allocable to each of the interested countries. Czechoslovakia, however, permits the deduction only in respect of the interest on general indebtedness which is proved to be economically bound to the local establishment, as where the debt is secured by a *hypothèque* (somewhat similar to a mortgage) on the immovables of the local establishment. The only provision in Czechoslovak law for the apportionment of such interest relates to the special tax on company profits and states that, when it is not possible to allocate definitely items of expense to items of income, the items of expense can be apportioned in the ratio of gross income. The Czechoslovak-Polish treaty provides for apportioning expense in the ratio of gross income which is first allocated in relation to invested and working capital. Although Poland, in principle, allows a deduction of a proportion of interest on general indebtedness, it has no general rule because of the difficulty of prescribing one for all cases. Nevertheless, its authorities resort most frequently to using a ratio of the branch's share of capital or gross income, or its part of the general movement of the funds of the entire enterprise. The Greek authorities permit a deduction of interest if the capital borrowed has been unquestionably used by the local establishment (*e.g.*, in industrial installations, or construction of railways), and a proportionate part of the interest if only a part of the loan has been invested in Greece.

353. Similarly, Japan allows the deduction of interest on a loan contracted solely to finance trading operations in Japan, and, if only a part of the loan is used there, the apportionment may be effected on a reasonable basis — *e.g.*, gross income or fixed assets.

354. Although Cuba and Mexico allow a deduction of the interest corresponding to the part of the loan definitely used in their respective territories, Mexico conditions this allowance upon the payment of the tax on interest.

355. As previously stated, the United States allows a deduction of a rateable part of interest which cannot definitely be allocated. Wisconsin, when taxing a local branch on its separate accounts, allows a rateable part of the total interest, which is usually determined by the ratio of property in Wisconsin to total property, or sales in Wisconsin to total sales, or some other factor dependent upon the circumstances of the case. It is necessary that the interest actually be paid to outsiders and not represent interest arbitrarily imputed to the use of capital within the business. The New York State personal income-tax authorities permit an apportionment of the interest, ordinarily in accordance with the percentage derived from the prescribed allocation factors.

356. The countries which do not allow a deduction of a proportionate part of interest on general indebtedness include the following :

United Kingdom and the Irish Free State : Because no annual interest is admitted as a deduction in determining the amount of the assessable profits. ¹

Belgium : Because the Belgian administration considers such interest constitutes a charge of the real centre of management, unless the debt was contracted in Belgium by the local establishment for its exclusive use, in which case the *taxe mobilière* must be paid on the interest.

Italy : Because the deduction of interest is permitted, only if the name of the creditor is given and if the creditor has its domicile in Italy. This rule may be modified in practice by allowing a deduction of interest on money borrowed by the parent to organise the Italian branch.

The Netherlands : Because only debts contracted to meet the needs of the branch operations may be deducted.

Estonia and Latvia : Because they apply as rigidly as possible the method of separate determination of branch income, the former requiring that interest on debts of the local branch be shown in a special account of the branch.

Roumania : Because such interest is imputed solely to the real centre of management abroad, and even if the real centre of management advances a part of its capital to the branch, the latter may not deduct interest from its taxable profits, because the law requires that the creditor have a personality distinct from the debtor.

Austria distinguishes between interest on long-term loans and that on short-term loans. In order not to treat loan capital different from share capital, interest on bonds or debentures is not deductible from gross income. On the contrary, interest on short-term loans is deductible, provided it is shown that the loan was used by the branch ; and, if an apportionment were necessary, it might be effected in the ratio of turnover.

357. With regard to the countries applying fractional apportionment, the Spanish report states that, through the application of the comparative ratio, interest on general indebtedness is apportioned in the same ratio as profits. This principle is so strictly applied that the interest on bonds sold during the war of 1914 by companies in belligerent countries almost exclusively to subscribers in Spain was taxed in Spain only in proportion to the business of the debtor in that country. As the fiscal administration always views the enterprise as a whole, its total bonded debt is considered in relation to its total assets. The only distinction of importance made is that between secured indebtedness on the one hand and debts relating to the exploitation and administration on the other. Such debts are charged to each establishment in accordance with commercial practice. The same rule is followed in the case of credits extended or obtained by the branches of foreign banks, other than those subject to the Anglo-Spanish treaty. ² Similarly, in the Swiss system of fractional apportionment, the interest on debts is apportioned in the same measure as the profit, whether the debts have been contracted abroad or by the Swiss establishment and whether the interest is paid by the one or the other.

General Overhead.

358. The number of countries, which, in principle, allow a deduction of a certain proportion of overhead expenses of the real centre of management abroad from the gross profits of the local branch, is even greater than the number which allow a deduction in respect of interest on general indebtedness, but the conditions under which this allowance is granted are, in some instances, so strict that the taxpayer is seldom able to satisfy the tax authorities that the requested allowance is

¹ United Kingdom Income-Tax Act of 1918, Schedule D, Rule 3 (1), of the Rules applicable to Cases 1 and 2. This provision prohibiting any reduction in respect of annual interest ensures collection of tax at the source on the full profits, and, on paying the annual interest, etc., a company would normally be entitled to deduct income tax at the standard rate and thus pass on the burden of the tax in respect of the interest to the recipient thereof.

² *Inriz*, paragraph 486.

justified. The one country which has a specific provision in its law for allowing such a deduction is the United States of America, its Revenue Act permitting a deduction from gross income from sources within the United States of a rateable part of expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. This rateable part is based upon the ratio of gross income from sources within the United States to total gross income.¹ The practice in the States which tax on the basis of a separate determination of the income of the local branch in accordance with its accounts is substantially the same — that is to say, they first allow the deduction of expenses definitely allocable to the local branch, and then an apportionment on some reasonable basis of the balance of general overhead, provided the taxpayer justifies this allowance. The countries which, in principle, grant this allowance for general overhead include, in addition to the United States: the United Kingdom, the Irish Free State, British India, Canada, South Africa, France, Luxemburg, Italy, the Netherlands, Netherlands East India, Sweden, Germany, Danzig, Austria, Czechoslovakia, Hungary, Estonia, Latvia, Poland, Greece, Roumania, Japan, Cuba, Wisconsin and New York, with regard to the personal income tax.

359. Obviously, the question of apportioning general overhead does not arise in countries like Spain and Switzerland, which subject the total net income of the enterprise to fractional apportionment. Wisconsin, however, in applying its allocation fraction to branches engaged in manufacturing, assembling or processing, sometimes apportions a part of the general overhead to the activities within Wisconsin in order that it may serve as a factor in subsequently applying the allocation fraction to the net profit. The only administrations which state that they do not make any allowance for general overhead are those of Belgium (which is bound by the requirement that only expenses incurred by the local establishment are deducted),² and Mexico.

360. A notable exception to this principle is that no specific allowance is given for the general overhead of an enterprise with the real centre of management abroad, if a proportionate part thereof has been included in the price at which goods have been invoiced to the local sales establishment, or in the amount charged to the branch for advances or services of any kind. This exception is emphasised by the authorities of the United Kingdom, the Irish Free State, Canada, Italy, the Netherlands and Greece.

361. In the few cases where the United Kingdom authorities grant a specific allowance, the method usually followed is to apportion the overhead expenses by reference to turnover or some other factor appropriate to the particular case. Even in the case of banks, insurance companies and other non-manufacturing companies, specific claims to deduct a proportion of such expenses are exceptional. If the company is assessed on a conventional basis — for example, a premium basis for insurance companies or an assets basis for banks — the overhead expenses would usually be taken into account in arriving at the total profits of the enterprise and, consequently, in arriving at the appropriate United Kingdom proportion. A few insurance companies, which have been taxed on a premium ratio, have been given a specific allowance for overhead, for example 2 per cent, and occasionally foreign banks with local branches have been allowed the same proportion of general overhead expenses as the London branch expenses bear to the expenses of all the branches. The situation is essentially the same in the Irish Free State.

362. The British India fiscal administration, in making this allowance, states that, if the method of fractional apportionment is adopted with reference to gross profits, and it is necessary to work out the deductible expenditure corresponding to the British India share of the gross profits, the general overhead of the centre of management abroad is apportioned, usually on a turnover

¹ Revenue Act of 1932, Section 119 (b), Regulations 77, Article 68o.

² Co-ordinated Laws, Article 27, paragraph 4.

basis, unless a closer estimate can be made from other available data. If, however, the profits arise from the sale in British India of goods purchased or manufactured abroad, the whole of the profit is allocable to British India, and only actual expenditures, including those made abroad, are deductible.¹

363. The Canadian authorities subject this allowance to the condition that the head office expenses have a close relationship to and benefit the activities in Canada. Thus, if the real centre of management (central management and control) not only exercises a general control and direction over the policies of management and the activities in Canada, but also conducts international advertising, which stimulates sales in Canada as well as in the home country, some deduction for such expenditure may be allowed. The amount of the allowance and the method of apportionment would depend on the facts of the particular case, and no consideration would be given to the tax paid in the country where the real centre of management is situated.

364. Although the South African authorities permit the deduction of a reasonable proportion of general overhead expenses which are sufficiently linked with the profit-earning operations conducted in the Union, they declare that no general principle can be laid down governing such an allocation, and each case is determined in accordance with its facts.

365. The French practice requires that expenses definitely attributable to the branch should be allocated to it — for example, if a foreign enterprise has a central service to keep in touch with the operations of its French branch, and if the expenses of that service are accounted for separately, the amount thereof should be deducted from the gross profits of the branch. A proportion of the remaining expenses of the centre of management abroad may be ascribed to the branch, provided they pertain to the enterprise as a whole — for example, directors' fees, expenses of management and centralised accounting. Luxemburg conditions the allowance upon the usefulness of such expenditure to the local establishment.

366. In Italy, the price at which goods are transferred from the foreign parent to the local branch is verified, in order to ascertain whether it includes a fraction of general overhead, by making a comparison with the current market price to outsiders which contains general overhead. In the absence of a transfer of goods, the legislation envisages no precise rules for the apportionment of general overhead, but the fiscal authorities will determine the allowance in each case in proportion to the business of the branch. In practice, this fraction will be included in the estimated amount which embraces all the expenses to be deducted from the gross income of the branch.

367. The Netherlands allows this deduction only to the extent that such overhead of the real centre of management abroad pertains directly to the activities of the local branch; but the taxpayer rarely can prove this relation.

368. The Netherlands East Indian authorities are somewhat more liberal, granting the apportionment in the ratio of the importance of the local branch in the business complex. If the foreign company has only its head office abroad and its business in Netherlands East India, which is frequently true of agricultural and mining enterprises, the profits are put down in total as East Indian profits, and the overhead expenses are, as a general rule, deducted therefrom. Some taxpayers contend that charges and commissions made for services to the local branch should be deducted from the East Indian profits, but the opinion of the administration that such deductions should not be allowed has been confirmed by the Court of Tax Appeals. According to the

¹ Indian Income-Tax Act (XI of 1922), as amended, Section 42(3).

administration,¹ although it might be fair to allow such deductions in the case of banks, and import and export enterprises, it will never be easy in those cases to settle the question directly in figures.

369. Germany, Danzig and Czechoslovakia apply the test of the economic connection of the overhead expenses to the local establishment. Austria, in allowing a deduction of a reasonable proportion of general overhead which really pertains to the Austrian establishment, frequently uses as a basis the ratio of turnover of the local establishment to the total turnover. Hungary applies the test of benefit to the local establishment.

370. In Estonia, an allowance is given, provided the branch administrative expenses and the general administrative expenses do not exceed in the aggregate 5 per cent of the capital fixed for the operations of the local branch.

Latvia conditions the allowance upon its being required by local necessity. The Polish authorities, in apportioning overhead, fit the method to the case.

371. The Greek authorities use the factors most appropriate to the relations existing between the branch and the real centre of management, and sometimes resort to a comparison with purely national enterprises. Roumania considers the cost of the real centre of management abroad only to a very limited extent, which rests with the discretion of the Tax Commission.

372. In Japan, the apportionment is usually effected in the ratio of gross receipts or other appropriate factors. Cuba conditions the allowance upon its being indispensable to the local branch.

373. The United States authorities declare that the deduction described above is most frequently claimed in connection with the remuneration of the principal executive officers of the foreign company. Wisconsin, when taxing on the basis of separate accounts, apportions overhead to the local branch, using the factor of sales more frequently than that of property. The New York State personal income-tax officials observe that the taxpayer who keeps separate branch accounts usually apportions the general overhead and enters the amount in the local books. This method is acceptable if the Commission is satisfied that the percentage is not excessive. No allowance is given if the general overhead is not entered in the books of the branch office.

APPORTIONMENT OF NET PROFIT OR LOSS.

374. In accordance with the principle of the separate determination of the profits of the local branch on the basis of its accounts, the great majority of countries tax the local branch without any regard as to whether the enterprise as a whole realised a profit or a loss. The income-tax laws impose the tax upon net income attributable to the local establishment, and if the local establishment actually suffers a loss, no tax is levied. On the other hand, countries applying fractional apportionment consider the enterprise as a whole, merging the profit or loss of the branch with that of the entire enterprise. It is evident, from the reports, that fractional apportionment is used more frequently to attribute a part of the earnings of a prosperous parent to a deficitary branch, than to throw a part of the profits of the local branch to its less prosperous parent. In fact, Spain, New York and Massachusetts impose minimum taxes to safeguard their revenues.

¹ "Taxation of Foreign and National Enterprises", Vol. III, page 23, paragraph 95.

375. Countries, which, as a rule, assess the local branch without any regard to the profit or loss of the enterprise as a whole, include the United Kingdom, the Irish Free State, British India, Canada, South Africa, Belgium, Luxemburg, France, Italy, the Netherlands, Denmark, Sweden, Germany, Danzig, Estonia, Latvia, Poland, Greece, Roumania, Japan, Cuba, Mexico and the United States.

376. If, however, the authorities of the countries mentioned are not convinced that the loss is *bona fide*, they may, in many instances, either resort to empirical assessment on the basis of information locally obtainable, or demand the submission of the balance-sheet, profit-and-loss statement or other accounts of the real centre of management abroad, in order to apportion a part of the total net income to the local establishment.

377. The German administration points out that the situation of the parent is immaterial when it taxes the local branch on some empirical method over a period of years, such as on its turnover or on the basis of a lump sum, and the Hungarian report declares that, in any event, it would assess a local branch showing a loss either by applying an empirical method or by fractional apportionment.

378. The viewpoint of the Netherlands East Indian authorities on this subject is of special interest, because of their tendency to regard the importance of the branch in the enterprise as a whole. If the enterprise consists of only a buying establishment outside Netherlands East India and a selling organisation in that country, and realises a total loss, no profit will be allocated to the East Indian branch. If, however, there is only one buying establishment abroad and several selling establishments in Netherlands East India and in various other countries, it is quite possible, that some profits will be allocated to the East Indian branch, even though the whole enterprise has been working at a loss. This is considered logical in view of the fact that the possibilities for making profits in different markets vary considerably. In such cases, the administration believes that to make a proper assessment it is necessary to make an exhaustive analysis of the business itself and a careful comparison with similar enterprises operating in Netherlands East India. In the opposite case, where the foreign company has nothing but a wholesale buying organisation within Netherlands East India, it might be assessed on the basis of a buying commission (in default of a better method), although the enterprise as a whole suffers a loss. Similarly, if the foreign company operates a plantation or mines in Netherlands East India, manufacturing the raw products into finished article abroad and selling them abroad, the East Indian profit can justly be taxed, even though the business as a whole works at a total loss because of losses sustained in the manufacturing abroad of the raw material, or in the selling abroad of the finished product. The East Indian profit would be delimited by the price obtainable for the raw product in the world markets.

379. Under the treaties in force between Austria and Czechoslovakia and Austria and Hungary, obviously, if any joint profit is derived — for example, through purchasing in one country and selling in the other, or through manufacturing in one country and selling in the other — each country receives its fraction of the net profit regardless of whether the establishment in its territory actually realises a loss, and the entire profit from the joint operations was realised or derived from the activities in the other country. The treaty between Czechoslovakia and Poland has essentially the same effect.

380. The Spanish report states that the relative percentage fixed by the jury of experts is applied to the earnings of the enterprise as a whole, and the tax is levied on the amount thus apportioned to the branch, even though it is less than that revealed by the books of the branch. If, however, this method of assessment results in a loss for the branch, the tax will nevertheless be

imposed on its relative percentage of the amount representing 3 per 1,000 of the paid-up capital, plus reserves of the company (the minimum rate for companies).¹

381. The Swiss report observes that to apply the method of fractional apportionment, it is necessary to attribute the profits of the branch to the enterprise as a whole, whether or not the latter is deficitary, but, in practice, the cantons try to mitigate the results of the method which, in such a case, deprives them of the tax on income (although they still have the tax on the capital invested in the branch). On the contrary, the cantons are especially disposed to apply fractional apportionment when the whole enterprise realises a profit, while the local branch is deficitary, as, in many cases, the authorities do not know if the branch's deficit is real, or artificial as the result of arrangements in favour of the head office abroad.²

382. The Massachusetts report observes that the tax is imposed on the corporation as a unit, and if the allocation fraction throws a loss to Massachusetts, a prescribed minimum tax is nevertheless payable, the rate being one-twentieth of 1 per cent of the gross receipts attributable to Massachusetts. It continues :

“ The question of net income or net loss as to a given unit of activity is largely a matter of accounting. A business, in order to be successful, must have many activities that do not show their value, except as they may be reflected in increasing sales or decreasing costs. It is to be assumed that all business activities of a corporation are adopted for the sole purpose of making net income. This being so, the State in which any of these activities are carried on is entitled to a fair share of the total net income for the purpose of taxation. It is necessary to find a measure of allocation which allots a fair part for a given jurisdiction to tax. ”³

DUMPING.

383. Corporations sometimes resort to the practice of “ dumping ” their products in foreign countries, or selling them at such a low price as not to permit the branch to show any profits in its books, and this has caused many tax administrations considerable concern. Although they realise that it may take a local sales branch several years to make sufficient headway in the local market to reflect a profit, they are reluctant to believe that a corporation will continue to operate an actually unprofitable branch for ten or fifteen years — many foreign corporations declaring a loss even for this period of time. It is the continual declaration of losses by an enterprise that usually prompts tax administrations to resort to an empirical assessment or fractional apportionment. Many officials believe that the local branch would not be continued in operation if a profit were not realised by the foreign enterprise, in any event, through increasing the volume of output and thereby permitting the spread of general overhead over a wider basis, with the result that the cost of each unit of production is reduced and a wider margin of profit realised on the articles sold by the enterprise at a normal market price. A number of officials have expressed the view that Governments should not attempt to combat “ dumping ” by arbitrary use of the income-tax, but rather by imposing heavier Customs duties on the articles in question, or otherwise restricting or precluding their entry into the country.

¹ “ Taxation of Foreign and National Enterprises ”, Vol. I, page 130.

² *Ibid.*, Vol. II, page 453.

³ *Ibid.*, Vol. III, page 204.

CHAPTER VI.**FOREIGN ENTERPRISE WITH LOCAL SUBSIDIARY — ALLOCATION CRITERIA.****INTRODUCTION.**

384. Enterprises carrying on business in two or more countries, especially if countries have different language, currency and economic conditions, very frequently organise a company in each country in conformity with the requirements of its commercial or company law. Thus, instead of extending its operations into each country through a branch of its own organisation, the parent enterprise conducts its operations through a subsidiary, which, in law, is a separate legal entity. The parent must therefore, in strict law, deal with the subsidiary company as if it were a separate legal person. In other words, the legal transactions between the parent and the subsidiary should be conducted in the same manner as similar transactions between independent legal persons. As long as the inter-company transactions are carried on under the same circumstances and conditions and on the same terms as they would be between two entirely separate and independent persons, dealing with each other in an open market, and in a manner which is graphically described as at "arm's length", the tax authorities in general respect the separate legal existence of the subsidiary company and tax it on the basis of its own declaration as supported by its properly kept separate accounts. To verify this declaration and accounts, the tax authorities may enquire into the current of business between the local subsidiary and the parent company or other subsidiary companies of the parent, which may for convenience be termed associated companies, and scrutinise carefully the results of interlocking transactions. If this is difficult, they may resort to a comparison with similar enterprises and make an empirical assessment upon the basis of turnover, or in accordance with one or another of the empirical methods described above in discussing the allocation of profits of local branches of foreign enterprises. Such is the situation in the great majority of countries — notably in South Africa, Belgium, Luxemburg, France (with regard to the tax on industrial and commercial profits), Italy, Denmark, Sweden, Danzig, Czechoslovakia, Estonia, Latvia, Poland, Roumania, Japan, Cuba and Mexico.

385. If the relations between the local subsidiary and the foreign parent are not carried on at arm's length, with the result that the profits are diverted from the local subsidiary to the foreign parent, other countries are inclined to reach out to the parent in order to restore to the subsidiary the profit diverted from it, or else assess the parent itself on the diverted amount. The methods of diverting profits which occasion most frequently this assessment of the parent are : billing to a subsidiary sales company at such an inflated invoice price as to allow little or no profit to appear in the books of the latter, or purchasing from a subsidiary manufacturing company at so low a price as to leave it little or no manufacturing profit. Other methods of diverting profits that are listed in the various reports include : (1) leasing property or equipment owned by one company to the other without charge or for a nominal or excessive charge, (2) the payment of commission to officers or employees by one company, although the services are rendered to another ; (3) the purchase and payment by one company of supplies, fuel, water, light, etc., which are used by the other company ; (4) one company makes loans to the other without interest, or, on the contrary, at an excessive interest rate ; (5) one company makes excessive charges to the other for patent royalties or other

services of various kinds ; or, on the contrary, performs services for an inadequate or nominal remuneration, often fixed by contract ; (6) one company may shift profits to another through an improper manipulation of accounts.

386. Although the methods used and theories invoked in reaching the parent are quite varied, broadly speaking, they consist of three general categories : (1) readjustment on basis of independent persons — *i.e.*, the legal fiction is respected, but the relations between the two are examined in order to divide the joint profit between them in the measure that each would have earned had the two been dealing with each other as independent persons ; (2) assessment of the parent in the name of the subsidiary as agent ; (3) assessment on basis of economic unity — *i.e.*, merging the subsidiary with the parent on the theory that they both constitute a single economic unit, or that the subsidiary is merely an organ of the parent.

READJUSTMENT ON BASIS OF INDEPENDENT PERSONS.

387. The first method, that of reapportioning the profit in accordance with what would have been earned by independent persons is typified by the United States Revenue Act of 1932, Section 45.¹ Under this provision, the Commissioner of Internal Revenue may request of the local subsidiary company all accounts and information necessary to allocate or apportion the income or deductions between the two companies in such a manner as to prevent evasion (by shifting of profits, the making of fictitious sales and other methods frequently adopted for the purpose of "milking" the one or other), in order to arrive at the true tax liability of the local company.²

388. The Canadian law contains a provision which is fundamentally the same, but is much more precise in its language and limited in scope. Thus, a subsidiary company organised under Canadian law is treated as an independent legal entity, but "where any corporation carrying on business in Canada purchases any commodity from a parent, subsidiary or associated corporation at a price in excess of the fair market price, or where it sells any commodity to such a corporation at a price less than the fair market price, the Minister may, for the purpose of determining the income of such corporation, determine the fair price at which such purchase or sale shall be taken into the accounts of such corporation".³

389. The Austrian practice embodies both the first method and the second method. A local subsidiary company is regarded as a legal independent organism, but if there is evidence of diversion of income through artificially fixing invoice prices, the administration will adjust the price between the subsidiary and the parent, and permit the subsidiary to participate in the adjustment. The alterations are based on a comparison with information furnished by similar enterprises, at existing market prices, or, in the absence of such evidence, on the opinion of experts. The experts consulted are usually merchants in the same or similar branches of business, exclusive of competitors or persons directly participating in the enterprise. Corrections of this kind do not involve the taxation of the foreign parent company.⁴

¹ "In any case of two or more trades or businesses (whether or not incorporated, whether or not organised in the United States and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorised to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses."

² "Taxation of Foreign and National Enterprises", Vol. I, page 253.

³ Canadian Income War Tax Act, chapter 97, R. S. C. 1927, as amended, Section 23.

⁴ "Taxation of Foreign and National Enterprises", Vol. II, pages 31 and 32.

ASSESSMENT OF PARENT IN NAME OF SUBSIDIARY AS AGENT.

390. If, however, the relations between the foreign parent and the Austrian subsidiary are in fact those of principal and agent or employer and employee, with the result that the subsidiary is tantamount to an establishment of the foreign parent, then the fiscal administration may tax the parent itself on the profits deemed to arise in Austria, the allocation being effected as in the case of an Austrian branch.

391. In the law of the United Kingdom the local company is taxed as a legal entity on the basis of its separate accounts, but, if, owing to the substantial control exercised by the parent and the close connection between the two companies, the course of business is so arranged that the subsidiary shows profits less than ought to be expected to arise from its business, the parent may be charged through the subsidiary as agent upon its true profits.¹ Generally, when this rule is invoked, the percentage of turnover method is employed to determine the profits as in the case of an ordinary agency or branch. The British Rule has been incorporated in the Irish Free State Income-Tax Act.

392. The principle in the United Kingdom Act is clearly intended to enable the Commissioners to recover tax on profits diverted from the local subsidiary to the foreign parent. In British India, where also a local subsidiary company is regarded as an independent legal entity, the same principle of taxing the parent in the name of the subsidiary as agent has been invoked, but without predicating recourse to this measure upon diversion of profits. In the case of a foreign manufacturing company which sold its products to a subsidiary company registered in Bombay, the latter marketing the products in a district of British India, the Privy Council held that, apart from the liability of the Bombay company, the foreign company was liable to (1) income-tax and super-tax under Section 42(1) of the British India Income-Tax Act upon profits derived from selling goods to the Bombay company; and (2) to a super-tax under the same section upon dividends received from the Bombay company.² The grounds for this decision were that the Bombay company was formed for the express purpose of acquiring from the American company, and carrying on in a particular area, the American company's business of selling its manufactures. Although no contractual obligation existed by which the Bombay company was compelled to purchase any of the products of the American company, the flow of business between the two was secured by the fact that the ultimate and complete control of the Bombay company was vested in the foreign company which owned virtually all its shares. The opinion stated that it is not a question whether the Bombay company is, in law, an agent of the foreign company, but whether the facts of the case are such that the Bombay company can properly be deemed to be such agent under Section 43. Their Lordships were of the opinion that such business existed under Section 43, and also under Section 42 (1) as to entail liability for the parent company. As the necessary business connection was established, their Lordships concluded that the profits and gains in question accrued or arose to the American company "directly or indirectly through or from a business connection in British India", and were accordingly taxable. The assessment made in the name of the Bombay subsidiary, as agent for the parent company,

¹ General Rule 7, Income-Tax Act of 1918, reads :

" Where a non-resident person, not being a British subject or a British, Indian, dominion or colonial firm or company, or branch thereof, carries on business with a resident person, and it appears to the Commissioners by whom the assessment is made that, owing to the close connection between the resident person and the non-resident person, and to the substantial control exercised by the non-resident person over the resident person, the course of business between these persons can be so arranged, and is so arranged, that the business done by the resident person in pursuance of his connection with the non-resident person produces to the resident person either no profits or less than the ordinary profits which might be expected to arise from that business, the non-resident person shall be assessable and chargeable to tax in the name of the resident person as if the resident person were an agent of the non-resident person."

² Commissioner of Income-Tax, Bombay v. Remington Typewriter Company (Bombay), Limited ; Bombay High Court, 3 I.T.C. 166 ; Privy Council (1930), 5 I.T.C. 177.

included on the same grounds, income-tax and super-tax on profits derived from selling to two other subsidiary British Indian companies, and also super-tax on dividends received from them.¹

393. In any event, under British Indian law, if the accounts of a subsidiary company are not satisfactory, it may be taxed under Section 42 (2), provided the parent is not a British or Dominion company, or under Rule 33² as having a business connection with its non-resident parent. Section 42 (2) provides that if a non-resident, not being a British subject or a company or firm constituted within His Majesty's Dominions or a branch thereof, carries on business with a resident, and if, owing to the close connection between the two and to the substantial control exercised by the non-resident over the resident, the course of business is so arranged that the resident realises therefrom either no profits or less than the ordinary profits which might be expected to arise, the income-tax officer can assess the resident on the basis of estimated profits. In this case, the resident is assessed as the principal and not as agent for the foreign parent. If the subsidiary is a sham, it would be open to the income-tax officer, even if the company were a British or Dominion company, to assess it on its true nature as a branch of the parent company and not as a separate company.

ASSESSMENT ON BASIS OF ECONOMIC UNITY.

394. In another group of countries, the tax authorities have justified assessing the foreign parent company itself on the grounds that, in fact, the local subsidiary and the parent form a single economic unit (*wirtschaftliche Einheit*), and in Germany this viewpoint of the administration has been upheld by the courts. In that country, another theory has been developed for the same purpose in accordance with which the foreign parent company is taxable on the grounds that the local subsidiary company is merely its organ (*Organtheorie*).³

395. The economic unity theory may be invoked by the Spanish administration in the following cases: (a) when the managers of the company are of Spanish nationality, or when, though they are of Spanish nationality, there are not enough of them domiciled in Spain for them to make decisions; (b) when the persons legally responsible for the management of the company are under the control of the foreign company, whether because they are officials of the foreign company, or in consequence of contracts or agreements; (c) when the registered name of the company or the additional indications used by it in published documents and business papers make it clear that the company is operating in Spain under the control of a foreign company; (d) when the administration has valid evidence that the foreign company holds such a large proportion of the securities representing the Spanish company's capital that it can enforce its decisions at general meetings of shareholders and in the business management of the company. The Spanish administration must first make a declaration to the effect that the Spanish company is in complete union with the parent company on one or more of the above grounds. If the Spanish company accepts the declaration, or, in the event that it refuses to do so, if the administration's decision is upheld by the competent tribunal, the Spanish company is liable for tax as if it were a branch of the parent company. As a matter of fact, however, there has not been a single case in which the administration's declaration has not been accepted by the subsidiary company.⁴

396. The Swiss cantonal authorities, in order to respect the legal personality of the subsidiary, endeavour to avoid, as much as possible, merging the subsidiary company with the parent, reserving of course their right to modify the result of the subsidiary company's accounts when they ascertain that the arrangements with the foreign parent favour the latter and do not correspond to trade

¹ "Taxation of Foreign and National Enterprises", Vol. III, pages 38 and 39, paragraph 109.

² *Supra*, paragraph 36.

³ Decisions of the Reichsfinanzhof, November 23rd, 1926, October 11th, 1928, IA 473/27, and November 16th, 1930, IA 129/30, discussed by Joh. LÖFFLER in "Die Organtheorie im Steuerrecht", *Deutsche Steuer Zeitung*, January 1931, No. 1.

⁴ "Taxation of Foreign and National Enterprises", Vol. I, pages 160 and 161.

custom and competitive conditions. To treat a subsidiary company as a branch, the authorities invoke the economic unity theory or *Organtheorie*, the grounds for their application being considered to exist especially where the subsidiary operates as an intermediary establishment in the activity of the enterprise, or as an organ indispensable for that activity.

397. The Hungarian authorities may assimilate a local subsidiary to a branch where all its activities are directed towards furthering the interest of the parent, and the subsidiary is under the dominant control of the latter.

398. The Netherlands East Indian authorities likewise depart from their practice of treating the local subsidiary as an independent entity when it enjoys no independent existence from an economic viewpoint and is, in fact, entirely merged with the parent. They sometimes ascertain that the foreign parent does not, in its own book-keeping, treat the local company as a separate entity, but represents the parent as the *entrepreneur* of the local enterprise. The authorities frankly employ the term "dummy" in describing such a local company and point out that this word has a special significance in Netherlands East India, because the agricultural and mining laws of that country forbid the acquisition by companies organised elsewhere than in its territory or in the Netherlands of long leasing rights or of mining concessions. Consequently, foreign (not Dutch) companies can only carry on such enterprises in Netherlands East India through a representative, which as a rule is a subsidiary organised locally or in the Netherlands and holds the titles. If a local subsidiary company is managed in such a way that the intention to avoid taxation is plain, the administration is not bound by any fixed rules but may assess the parent company.¹

ASSESSMENT ON BASIS OF CONSOLIDATED ACCOUNTS.

399. In various States of the American Union — for example, Massachusetts, New York and Wisconsin — a method is employed which may, in essence, be considered the same as the economic unity theory, but is different from a legal viewpoint. Instead of merging the enterprises themselves, their accounts are consolidated for the purpose of arriving at the profits attributable to the local subsidiary company. A provision of somewhat similar import was formerly contained in the United States Revenue Act, but the phrase "consolidate the accounts" was eliminated from the wording of Section 45 to prevent erroneous interpretation of the provision in the 1926 (Section 240 (b)) and subsequent Revenue Acts.²

400. The Wisconsin Income-Tax Statute³ empowers the Commission to determine the taxable income of a local subsidiary, from which profits have been diverted, through price-fixing, to its

¹ "Taxation of Foreign and National Enterprises", Vol. III, pages 153 and 154, paragraphs 99 to 101.

² *Ibid.*, Vol. I, page 252.

³ Section 71, 25 (1), provides :

"When any corporation liable to taxation under this Act conducts its business in such a manner as either directly or indirectly to benefit the members or stockholders thereof or any person interested in such business, by selling its products or the goods or commodities in which it deals at less than the fair price which might be obtained therefor, or where a corporation, a substantial portion of whose capital stock is owned either directly or indirectly by another corporation, acquires and disposes of the products of the corporation so owning a substantial portion of its stock in such a manner as to create a loss or improper net income, the Commission may determine the amount of taxable income of such corporation for the calendar or fiscal year, having due regard to the reasonable profits which but for such arrangement or understanding might or could have been obtained from dealing in such products, goods or commodities.

"2. For the purpose of this chapter, whenever a corporation which is required to file an income-tax return, is affiliated with or related to any other corporation through stock ownership by the same interests or as parent or subsidiary corporations, or whose income is regulated through contract or other arrangement, the Tax Commission may require such consolidated statements as in its opinion are necessary in order to determine the taxable income received by any one of the affiliated or related corporations."

foreign parent, by regarding the reasonable profits which normally " might or could have been obtained from dealing in such products ". For this purpose, whenever the local taxpayer is related to any other corporation through stock ownership by the same interests or as parent or subsidiary corporations, or whose income is regulated through contract or other arrangement, the Tax Commission may require such consolidated statements as, in its opinion, are necessary in order to determine the taxable income received by any one of the related corporations.

401. One of the principal cases giving rise to the application of this provision involved a large foreign manufacturing corporation with a local sales subsidiary company. The profit of the sales corporation had been limited to a nominal figure by contract between it and the foreign company without any regard to the fair share of the ultimate profits realised through its activities. There have been other cases in which a local manufacturing corporation organised a subsidiary sales corporation under the laws of another State and transferred the product to its sales subsidiary at cost of manufacture or at a nominal profit, thereby reducing the income of the Wisconsin corporation. The payment of excessive royalties has been another method of diverting profits to a corporation outside the State. Whether the local corporation reports its income on a separate accounting basis or an apportionment basis, the authorities may combat the various schemes of shifting profits by invoking the above provision. In cases in which its application has been tested in the courts, the corporations involved were in two instances placed on a correct separate accounting basis, and, in another instance, the income of the parent and subsidiary corporations were consolidated and an apportionment fraction was determined and applied to the net consolidated income of the two. ¹

402. For the purposes of its corporate excise-tax, if the Massachusetts Tax Commissioner has reason to believe that the profits of a local company are being diverted to a foreign company, it is his practice to request a copy of the consolidated return which, under certain conditions, may be filed by a group of American corporations for the purpose of the federal income-tax. ²

The Massachusetts allocation factors are then applied to the consolidated income with a view to ascertaining the amount attributable to the activities of the Massachusetts corporation. Having ascertained its earnings, if the subsidiary carries on business outside Massachusetts as well as within, the allocation factors are again applied to determine the portion of the income allocable to Massachusetts. This " consolidated method " is recognised as determining merely a presumptive basis of taxation, and it will be set aside if an analysis of inter-company transactions reveals that it allots too great an amount of income to Massachusetts. ³

403. Similarly, for the purpose of the New York franchise tax on general business corporations, where substantially all the capital stock is owned or controlled by the same interest, the Tax Commission may require the filing of a combined return and impose the tax as if the combined net income and segregated assets were those of one corporation. The Tax Commission is given full discretion to require necessary information for determining the profits of a local company, the income of which has been reduced by purchasing goods from a foreign parent at an excessive price or by selling its products at less than a fair price. ⁴

TREATMENT OF DIVERTED PROFIT AS DIVIDEND.

404. France, Greece and the Netherlands have each developed special means of preventing the avoidance of liability to their respective taxes on dividends by diverting profits from the local company to the foreign company. The French tax on income from securities (*impôt sur le revenu*

¹ " Taxation of Foreign and National Enterprises ", Vol. III, pages 247 and 248.

² See Revenue Act of 1932, Section 141.

³ " Taxation of Foreign and National Enterprises ", Vol. III, pages 204 and 205.

⁴ *Ibid.*, Vol. III, page 229.

des valeurs mobilières) is payable on the profits which a local company distributes in the form of dividends and interest, and it is levied in addition to the tax on the profits themselves (*impôt sur les bénéfices industriels et commerciaux*). The methods of allocating taxable income to a local branch of a foreign company for the purposes of the latter tax on industrial and commercial profits have been described.¹ As diverted profits which may be reallocated to a French subsidiary company for the purposes of assessment of the tax on industrial and commercial profits may not be retained in the books of the French company and subsequently distributed as dividends, the French administration has in a number of cases attempted to recover the diverted profit by imposing its dividend-tax on the foreign company itself. The basis of taxation is the same proportion of the dividends distributed by the foreign parent as its assets represented by holdings in the French company bear to its total assets. In a number of recent cases, the lower courts of France² have upheld the administration on the grounds that the foreign company extends its exploitation into France through the French company, which it controls by means of owning a majority of the registered stock. In recent treaties, however, which the French Government has concluded with Belgium, Italy and the United States of America, this method of recovering tax from the foreign company has been replaced by treating the diverted profit as a dividend and collecting the tax thereon from the French subsidiary.³

405. The Greek company is taxed on its profits when distributed as dividends and not on the annual net profit itself. If, however, a Greek company incorporated subsequently to April 1st, 1926, fails to distribute a dividend of 5 per cent on its paid-in capital, it may be subjected to the tax on profits, in which case it will be subject to the same method of allocation as a branch of a foreign company. This method is likely to be used when goods are billed to subsidiaries at inflated prices.

406. A company organised in the Netherlands is normally taxable only on distributed profits, but, if the authorities ascertain that the profits available for distribution have been reduced through the foreign parent charging excessive prices for merchandise, services and the like, the authorities may treat the amount which, in their judgment, exceeds the normal amount — in the light of the subsidiary's accounts and other available data — as a distribution of profits subject to the tax on dividends. If the administration shows that it is likely that the subsidiary would not have been organised if the founders had not had the intention of avoiding certain taxes specified by the law, the subsidiary will not be deemed to be separate from the parent (Law of April 29th, 1925). When the administration adopts this measure, the subsidiary remains subject to the tax on dividends and *tantièmes*, and, moreover, the foreign company itself becomes taxable just as if it had a branch in the Netherlands, and the allocation methods described in connection with branches are applicable.

¹ *Supra*, paragraph 120 *et seq.*

² Case of Société de Neuhausen (1927), *R. E.*, March 1928, 8698, pages 159 to 164, *S. J.*, January 26th, 1928, pages 124 to 126; Boston Blacking Company (1928), *R. E.*, May 1928, 8734, pages 329 to 333, *S. J.*, May 3rd, 1928, pages 567 and 568; Société Malterie Franco-Suisse (1926), *S. J.*, January 3rd, 1929, pages 28 to 30; Swift Packing Co. (1929), *S. J.*, October 10th, 1929, page 1096. The first two cases mentioned have been appealed to the Court of Cassation. For a discussion of these cases, see "Taxation of Business in France", by Mitchell B. CARROLL, United States Department of Commerce, pages 82 to 85.

³ Treaty between France and Italy (Protocol, paragraphs 2 and 6), signed June 16th, 1930, "Collection", Vol. III, page 27, and Additional Agreement (Article 1), signed November 16th, 1931, "Collection", Vol. V; French ratification of both authorised by Law of July 13th, 1933 (*Journal Officiel*, July 14th, 1933). Treaty between France and Belgium (Article 8), signed May 16th, 1931, "Collection", Vol. V; French ratification authorised by Law of July 13th, 1933 (*Journal Officiel*, July 14th, 1933). Treaty between France and the United States of America (Article 4), signed April 27th, 1932, ratified by the United States on June 15th, 1932 (*Congressional Record*, Vol. 75, No. 150).

CHAPTER VII.

FOREIGN INDUSTRIAL AND COMMERCIAL ENTERPRISES.

INTRODUCTION.

407. The enterprises in this category present the most difficult problems in the whole field of allocation, and the preceding discussion of allocation methods relates primarily to them. In short, the general practice of the administrations throughout the world is first to look at the accounts of the local establishment of the foreign industrial or commercial enterprise in verifying its tax declaration, and then, if necessary — which is usually the case — to adjust the declaration and accounts, or to make an assessment by applying one of the empirical or fractional methods previously described. The difficulties arise because of the fact that most countries do not have in their laws any clear-cut precepts as to how much of the profit of the foreign enterprise should appear in the books of the local establishment, other than the fundamental principle that they should reflect the true income attributable to the activities of the establishment. On the other hand, companies, in the absence of guiding precepts, generally conduct their inter-establishment transactions as best suits their convenience. As a matter of fact, the principles of allocation in some countries are so grasping that foreign companies feel justified in resorting to measures which will limit the profits subject to tax therein.

408. In the case of commercial enterprises, which purchase raw materials or goods in one country and sell them in another through their own establishments, or of a unitary industrial and commercial enterprise which purchases raw materials at an establishment in one country, transforms them into finished articles at a factory in a second and markets them through various sales establishments in other countries, it is obviously difficult to determine how much of the total net income of the enterprise is attributable to each of the establishments that have conducted to its realisation. There are relatively few countries which, in their law or jurisprudence, specifically recognise that the income may be apportioned as between various establishments.¹ In general, the question as to whether liability will be incurred in respect of one kind of establishment or another depends on the fundamental principles of the law regarding what gives rise to taxable income. It may be recalled that, in many European countries, the income-tax on industrial and commercial profits has succeeded to the *patente* or a similar tax, which in substance was a tax on doing business in an establishment within the territory of the State, and was computed on the basis of rent paid, the number of employees and their salaries, and similar factors. Consequently, one finds liability to the tax on commercial profits in France and Belgium contingent principally upon maintaining therein an establishment (*établissement*). Similarly, the liability of a foreign enterprise to the

¹ *Supra*, paragraph 24 *et seq.*

German tax depends primarily upon having in Germany an establishment (*Betriebsstätte*) or a permanent representative (*ständiger Vertreter*). The same precepts are either in the laws of other European countries, or, in practice, influence the administration of the tax. Throughout these countries, therefore, one finds the guiding principle that the income-tax is imposed on the profits attributable to the activities of the local establishment of the foreign enterprise.

409. In the United Kingdom and other countries in the British Commonwealth of Nations, foreign enterprises are subject to the guiding principle that they are taxable on profits derived from carrying on a trade or business in the country. The principal test of carrying on a trade is whether contracts for the sale of goods have been concluded in the country, but the merchanting profit may be separated from the manufacturing profit. As a corollary, a foreign enterprise manufacturing within the country for sale abroad may be taxed.¹

410. The United States taxes a non-resident enterprise on income from sources within its territory, but, in general, the non-resident is not held taxable unless he sells goods or services in the United States or produces or manufactures goods. The distinction between a manufacturing profit and a selling profit is expressly provided in the Regulations to the United States Revenue Act in Article 682, which provides for an allocation on the basis of the independent factory price.

411. In accordance with these fundamental precepts, the United Kingdom and the United States exempt mere purchasing establishments as well as research and statistical establishments and mere display rooms. Such establishments may be taxed, however, in countries which predicate tax liability upon the maintenance of an establishment of any kind within their territory. The prevailing practices in the above-mentioned and other countries in respect of the various types of establishments of industrial and mercantile enterprises will be described below in detail.

SELLING ESTABLISHMENTS.

Sale of Goods purchased abroad.

412. A local sales establishment of a foreign enterprise is taxable, in principle, only on profits pertaining to its sales activities in most of the countries covered in the survey, but, as has been previously stated, the views of the different administrations vary as to how much of the profit should be attributable to the sales activities. In practice, it appears that most countries distinguish between the sale of goods that have been purchased abroad and those which have been manufactured abroad. With regard to those which have been merely purchased abroad, the practice of the majority of countries is apparently not to make any allowance for a profit attributable to purchasing abroad. Thus, the United States Revenue Act, Section 119 (*e*), specifically provides that income derived from the purchase of personal property without and its sale within the United States, or *vice versa*, shall be treated as derived entirely from sources within the country in which sold — *i.e.*, the country in which the contract of sale was concluded.² The law of British India allocates the whole of the income from the sale of goods in British India to that country, regardless of whether they have been purchased or manufactured abroad.³ It is specifically stated by the administrations of the following countries that they make no allowance for a foreign purchasing profit: the United Kingdom, Canada, the Irish Free State, Japan, Cuba and Mexico. The same is apparently true in the following countries, as their practice is evidently to tax the local sales branch on the difference

¹ *Supra*, paragraph 31 *et seq.*

² G. C. M. 8594, IX-44, 4819.

³ British India Income-Tax Act (XI of 1922), Section 42(3).

between the sales receipts and the original cost price plus freight, insurance, storage, the expenses of the local sale branch, etc. : Belgium, Luxemburg, France, Italy, Denmark, Germany, Danzig, Hungary (except for companies subject to the treaty regime), Roumania, Estonia, Latvia, Poland, Greece and New York State with regard to its personal income-tax.

South Africa usually accepts as the cost price the invoice value used for Customs purposes.

413. The Netherlands authorities state that they pay little regard as to whether the goods sold at the local establishment were manufactured or purchased abroad, the only question being whether the invoice price to the local establishment is the same as that which would be paid by a separate entity. The authorities of Netherlands East India prefer that the goods purchased abroad be invoiced to the local sales branch at original cost in order that they themselves may apportion the income as between the purchase establishment and the local sales establishment in accordance with what they consider to be equitable. The invoice price would therefore not include a part of the head-office expenses or a part of the profits which the head office may attribute to its activities. The fiscal administration will determine the amount of the deduction to be allowed from the East Indian profit in respect of head-office expenses and also the amount of the profit realised there which is to be allocated to the purchasing office abroad as its profit. If the invoice price is above original cost, the administration will require information as to the basis on which it is computed. Formerly, the Netherlands East Indian authorities followed the principle that all profits are made on selling, but in recent years they have admitted an apportionment. As a rule, the buying of goods for importation into Netherlands East India requires much experience and commercial judgment, as it involves an enormous variety of merchandise. The authorities therefore believe that a part of the profits should be allocated to this buying. For the greater number of import enterprises, an allocation on the basis of 25 per cent for the buying and 75 per cent for the selling in Netherlands East India may be accepted as equitable and reasonable. They feel that it is the duty of every taxpayer to consider to what extent the circumstances of his own business justify a divergence from this standard. When a monopoly article is involved, there is a tendency on the part of the fiscal authority to allocate a larger part — for instance, 90 per cent — of the profits to East India. The reason for this is that, once an agency for these articles has been obtained, the buying is generally more or less automatic, being limited chiefly to the passing on of orders from East India.

414. Under the Spanish method of fractional apportionment, buying abroad may be taken into consideration in determining the relative importance of the local branch of the enterprise as a whole. The Swiss cantonal authorities, when apportioning the total net profit of a foreign enterprise which purchases abroad and sells in Switzerland, usually allow a *préciput* to the general direction abroad and allocate the rest to Switzerland ; if the enterprise both manufactures and purchases abroad, the apportionment is in the ratio of the productive factors, the importance of purchasing in the prosperity of the enterprise finding expression in a larger *préciput* to the head office abroad.

415. Under the law of Austria,¹ if a foreign enterprise purchases goods abroad and sells them in Austria, at least half of the income is allocable to Austria, the balance being attributable to the purchasing establishment abroad. In the treaties² which Austria has made with Czechoslovakia and Hungary, the profits derived from purchase in one country and sale in the other are equally divided. The Czechoslovak-Polish treaty³ implies an apportionment of the income from such transactions in the ratio of capital employed. In a treaty which France has concluded with the United States,⁴ provision is made for the reciprocal exemption of purchasing establishments. A similar provision is contained in the Treaty between France and Belgium.⁵

¹ *Supra*, paragraph 247.

² *Supra*, paragraph 249 *et seq.*

³ *Supra*, paragraph 265.

⁴ Article 1 ; *supra*, paragraph 404, footnote 3.

⁵ Article 7, § 4 ; *supra*, paragraph 404, footnote 3.

Sale of Goods manufactured abroad.

416. A more important problem is presented by foreign enterprises which sell in a given country goods which they have produced or manufactured abroad. The ordinary practice of tax administrators is to check the declared income by reference to the price at which goods have been invoiced to the sales branch, and have therefore served, in the case of most countries, as a basis for Customs duties. Many administrations complain that the taxpayer frequently invoices the goods at such an inflated value as to allow little or no profit to be realised by the sales branch. This practice on the part of foreign companies is said to depend somewhat upon the relative rate of the Customs duty as compared with the rate of income-tax. Obviously, if the duty is low, but the rate of income-tax is high, there may be a temptation to invoice the goods at an artificially high price. On the other hand, if the Customs duties are very heavy and are levied on an *ad valorem* basis, the foreign enterprise is more inclined to invoice the goods at as low a figure as possible, thereby throwing a larger profit to the local sales branch. Without going into the many considerations which may enter into the fixing of the invoice price, it may be said that in very few countries is there a close collaboration between the Customs authorities and the income-tax authorities in determining the value of the goods at the time of import. The income-tax authorities usually start by checking the invoice prices and making their own adjustments, or resorting to empirical assessments as previously described.

417. Under the law, jurisprudence or practice of the great majority of countries, the basis of assessment in these cases is the profit attributable to the sales activities of the local branch, as distinct from a manufacturing profit which may be said to accrue to the factory abroad. This principle is incorporated in Article 682 of the Regulations to the United States Revenue Act, which provides in substance for splitting the income between the sales establishment and the foreign factory on the basis of an independent factory price. Recourse to apportionment or to some other method of assessment is intended only when the determination of an independent factory price is impossible. Under the United Kingdom law, the foreign enterprise selling in, say, London goods which it has produced or manufactured abroad has the option of restricting the assessment to the "merchandising" profit — *i.e.*, the "profit which might reasonably be expected to have been earned by a merchant or, where the goods are retailed by or on behalf of the manufacturer or producer, by a retailer of the goods sold, who had bought from the manufacturer or producer direct".¹

418. This same rule is followed in the Irish Free State. The onus to show what is the merchandising profit rests primarily on the taxpayer. The administration would consider any relevant evidence available — for example, the rate of profit made by independent merchants dealing in the same or similar lines of goods, and, in certain cases, particulars of the prices at which goods were invoiced to independent merchants in neighbouring countries might be acceptable.

419. Similarly, in Japan, the whole of the profit derived from manufacturing abroad and sale by a local establishment is attributable to that establishment, unless the taxpayer satisfies the authorities that a reasonable profit should be allocated to the factory abroad.

420. Canada, in accordance with the general principle of apportionment contained in its law,² grants an allowance against the gross sales profit for: (1) cost of manufacturing abroad, and (2) some profit to be allocated to the manufacturing end and considered to arise in the foreign country. There is no definite precept as to the relative proportion of manufacturing and sales profit, this being determined by the fiscal authorities in accordance with the facts of each case.

¹ General Rule 12 of the Income-Tax Act, 1918; *supra*, paragraph 32, footnote 4.

² *Supra*, paragraph 42.

421. The Union of South Africa determines the profit of the sales branch as if it were a separate establishment, and the cost of the goods sold is taken at the price at which they are invoiced to the Union establishment and declared for Customs duty purposes. This may permit the throwing of profits to the foreign branches, but the officials have not found in experience any satisfactory method of meeting the situation without creating new difficulties, including raising questions of double taxation. They state that the safeguard to revenue lies in the Customs duties.¹

422. The Netherlands authorities verify that the invoice price to the local establishment is normal — that is to say, if it is the same as that which would be made to an independent entity. If the ascertainment of the normal invoice price is difficult, the authorities fix the gross sales profit at a fraction — for instance, half of the gross profit resulting from manufacture and sale. The Netherlands East Indian authorities, in endeavouring to tax only the local sales profit, consider the relative importance of the sales activities and those of manufacture. If only a part of the products of the foreign enterprise are sold in Netherlands East India, the calculation of the “ selling price ” from the factory to the export department of the enterprise may be subjected to a careful examination. The prices at which the export company invoices to the local sales company are subject to the same verification as that described above in connection with an enterprise buying abroad for sale in East India. Furthermore, the authorities may request information as to the prices at which the same goods have been invoiced to dealers or branches in other countries, or, if necessary, they may make a comparison with the prices of local competitors. If a company has virtually a world monopoly of a given product which it markets itself, the taxpayer often fixes the East Indian profit at a certain percentage of the selling price which may be accepted by the tax authorities after a careful examination of the accounts. A foreign company which manufactures articles especially for Netherlands East India usually markets them there, through its own sales branch or through a subsidiary company, which, in fact, is nothing more than a sales department of the company. The authorities consider that, in this case, the profits realised in Netherlands East India should be fixed at a fraction of the total net profit and deem it just to allocate to each of the two parts of the enterprise half of the profits, although the particular nature of the business may justify a different percentage. The authorities have noticed that the foreign taxpayer usually puts a high value on manufacturing profit and a low value on sales profit. Contrary to this, the East Indian administration is inclined to put a considerably higher value on sales. The reason for this tendency is the fact that, in the widespread over-production of recent years, sales effort has become a factor of paramount importance. If the sales branch in Netherlands East India markets, not only goods which have been manufactured by the foreign enterprise, but also goods which have been purchased (for example, to complete its line), the authorities would attempt to segregate the two categories and allocate the profits of each in accordance with what has been previously said.

423. Austria, in its law and in its treaties with Czechoslovakia and Hungary, has cut the Gordian knot by its adoption of definite fractions. Thus, under the law at least one-third of the joint profit derived from manufacture abroad and sale in Austria is allocable to the latter State, and under the treaties, two-thirds is ascribed to manufacture and one-third to sale.

424. In applying their apportionment formula, Spain and the Swiss cantons acknowledge that manufacturing effort is to be compensated as well as sales effort, but the apportionment is to be measured by factors which will necessarily vary with each case. In Wisconsin, a distinction between the two profits is admitted whether the local sales branch is taxed on its separate accounts or by application of the apportionment formula. The same is true in administering the personal income-

¹ “ Taxation of Foreign and National Enterprises ”, Vol. III, page 185, paragraph 95.

tax of New York. Recognition of this division of net profit is contained in the Massachusetts excise-tax and the New York franchise-tax on corporations.

425. In applying the principle of taxing income attributable to the activities of the local establishment, a distinction between manufacturing and sales profit is expressly acknowledged by France and Sweden, and is tacitly acknowledged by Belgium, Luxemburg, Italy, Denmark, Germany, Danzig, Czechoslovakia, Hungary, Estonia, Latvia, Poland, Greece and Roumania.

426. In Cuban law, there is no express provision which authorises consideration of a manufacturing profit as an integral part of the export price from the foreign country, but the authorities might accept invoice prices including a normal manufacturing profit, subject to the Law of September 23rd, 1932 (Article I, paragraph 5). The enactment of this measure was occasioned by the difficulties encountered by the administration in assessing the local branches, subsidiaries or agents of foreign companies which received goods billed at such high prices that the margin of profit shown in Cuba was insufficient to cover the selling costs. The new law provides that a tax of 3 per cent on gross receipts from all sources will be paid in substitution for the tax on net income by foreign companies which realise operations in Cuba through branches, subsidiary companies, agents or legal representatives, and fix by contract or otherwise the cost price and the sale price of their merchandise, without showing in a manner worthy of belief and to the full satisfaction of the administration the correctness of these prices, and provided the administration is convinced that, due to this method of operation, no profits can be realised by the business in question. The same applies to cases in which local companies make contracts with foreign companies to realise operations in Cuba and stipulating as compensation a certain percentage of the receipts which are obtained in Cuban territory, through the sale, leasing, exhibition or other disposition of the articles shipped.

427. The two countries which specifically make no allowance for a foreign manufacturing profit are British India and Mexico. The former, as stated above, has written this principle into its law, stipulating that all income derived by anyone from the sale of goods in British India shall be deemed to arise and to be received there.¹ In Mexico, the foreign enterprise is taxable on the entire profit in excess of the cost of the goods and other allowable deductions, and the tax return of enterprises deriving a profit of over 100,000 pesos calls for the cost of the goods as well as the receipts derived from their sale.² In practice, the price at which the goods have been invoiced to the local branch by the foreign enterprise is taken as the cost price, especially if it has served as a basis for payment of Customs duties. This price is not conclusive, however, and if the assessment board considers it necessary, it will request full information as to the foreign cost of manufacture.

428. If the local establishment of the foreign enterprise sells goods which, in part, have been manufactured abroad and, in part, purchased abroad, under the principles described above as applicable in the majority of countries, the profits pertaining to each category should be segregated for purposes of allocation or apportionment. This, of course, is not necessary in British India and Mexico. If the foreign enterprise does not itself make this segregation and allocation or apportionment, so that a proper assessment can be made in accordance with the principle of separate accounting, the tax authorities are not likely to make any distinction between the two categories, especially where it is necessary to resort to an assessment on an empirical or fractional basis.

Local Establishments selling abroad.

429. If a foreign enterprise with its real centre of management in one country has a branch in

¹ British India Income-Tax Act (XI of 1922), Section 42(3).

² Mexican Income-Tax Regulations, Article 28, paragraph 1.

a second country which makes sales in a third country in which the enterprise has no permanent establishment, the practice in the majority of States is to ascribe to the branch in the second State the profits derived from sales in the third State. These countries include : Belgium, France, Italy, the Netherlands, Netherlands East India, Switzerland, Sweden, Germany, Danzig, Austria, Czechoslovakia, Hungary, Latvia, Poland, Greece, Roumania and Japan. It is to be noted that these are primarily countries which base income-tax liability upon the activities of an establishment within their territory. Such is the practice in Belgium, even though the sale in the third State must be authorised by the real centre of management abroad. The Netherlands authorities follow this practice, because they are inclined to consider sales attributable to the country where the sale was prepared and negotiated rather than the place where it was formally concluded. In applying this principle, the Netherlands East Indian authorities would take into consideration the contentions of the head office that the profits were due partly or entirely to its activities.

430. In a second group of countries — notably those in the British Commonwealth of Nations and the United States — the question as to where profits are to be ascribed in a given case depends upon certain legal tests. Under the law of the United Kingdom and the Irish Free State, if a non-resident makes sales to another non-resident through a resident person, liability to income-tax does not necessarily arise.¹ Under the law of those countries, the place of residence is determined by the location of the "central management and control". If the foreign enterprise with a branch in, say, London or Dublin, which sells in a third country, is managed and controlled abroad, there would normally be no liability in respect of profits from sales in the third country. This statement presupposes that the contracts of sale are concluded in the neighbouring countries, because, if the contracts were concluded in the United Kingdom or the Irish Free State, the profits might be deemed to arise there. The United Kingdom authorities state, furthermore, that, if the business of the foreign company is managed and controlled in the United Kingdom, the profits derived from sales in the third State would be taxable in the United Kingdom.

431. The British Indian authorities would tax sales made by the local establishment of a foreign enterprise in countries in which it had no establishments if the contracts were concluded in British India. If the contracts were concluded elsewhere, the profits would be taxable if they were received for the first time in British India. Likewise, Canada would tax such profits if the Canadian establishment accepted contracts solicited by its salesmen in a neighbouring country. If, however, the sales contract were accepted in the neighbouring country or at the foreign head office, no attempt would be made to tax the profits attributable to the activities of the salesmen in neighbouring countries, and their expenses would be disallowed in determining the Canadian profits.

432. South Africa follows essentially the same principles : thus, if orders were taken in Rhodesia and the sales were confirmed by the Union branch, the latter would be taxable just as much as if it effected the sales directly to the Rhodesian customer. In either case, liability would not be affected by the fact that the goods sold might be delivered direct to the Rhodesian customer from another branch of the enterprise. If, however, the sales were effected outright in Rhodesia and only delivery were made from the stocks held by the Union branch, the resulting profit would not be subject to the Union tax.

¹ Rule No. 11 of the General Rules applicable to Schedules A, B, C, D and E, Income-Tax Act, 1918, reads :

" The fact that a non-resident person executes sales or carries out transactions with other non-residents in circumstances which would make him chargeable in pursuance of these rules in the name of a resident person shall not of itself make him chargeable in respect of profits arising from those sales or transactions "

433. In accordance with the principles of the United States income-tax, the profit would be allocated to the place where the sales contract was concluded, which is admitted to be a very difficult question of fact. The Income-tax Commission of Wisconsin and the New York State personal income-tax authorities would be inclined to ascribe such profits to the local branch, the former especially if the salesmen sent to neighbouring States solicited orders which were filled out of stock at the local branch, the remittances being made to such branch. The Wisconsin authorities are even inclined to believe that the profits should be allocated to the Wisconsin branch if the orders solicited by its salesmen were filled out of a stock maintained outside Wisconsin.

434. The Mexican authorities state that they would ascribe the profit from sales in a neighbouring State to the local branch if they were realised through its activities — that is, if the contract of sale were made there or if the delivery of goods or payment therefor were effected there. The Cuban authorities are not aware of any such cases, but they indicate that under their law a non-resident is taxable if income is obtained in Cuba, or payment is made in Cuba by a debtor outside Cuba.

435. Estonia and Spain apparently stand alone in holding that such profits should not be ascribed to the local branch, the latter country imputing such operations to the central management even if they are dealt with and accounted for — that is to say, “controlled”, in the strictest sense of the term — by the Spanish branch. The case is very frequent in Spain, because the Spanish branches of foreign companies also very frequently handle business in Portugal and Morocco.

MANUFACTURING ESTABLISHMENTS.

436. The rule is universal that, if a foreign enterprise manufactures in a given country and sells in other countries, a profit is attributable to the manufacturing establishment. In most countries, however, the administrative authorities are in doubt as to how much of the profits should be ascribed to the local plant. It is apparently the consensus of opinion in the majority of States that this profit should be that pertaining to manufacture as distinct from sale in neighbouring countries. If, however, the sale is made direct from the factory to dealers or customers in the foreign country, the whole of the profit is ascribed to the factory. A distinction is made between enterprises manufacturing textiles, machines or the like and those which extract minerals or conduct plantations for the production of rubber, sugar or other raw materials, and subsequently prepare them for sale on the world markets. The countries in which the latter category of enterprises are established, notably British India, Mexico and Netherlands East India, regard the world market price as the measure of profits allocable to their respective territories.

437. The United Kingdom Income-Tax Act of 1918 did not contain any specific provision on this point, and the courts have never been called upon to give a ruling, but the Board of Inland Revenue considers that, under the general principles of the United Kingdom Income-Tax Act, a profit may be ascribed to the local manufacturing establishment of a foreign enterprise. Furthermore, the report of the Royal Commission on the Income-Tax, 1920,¹ approves the principle of distinguishing the local manufacturing profit from the merchanting profit derived on sale abroad.

438. Under Canadian law,² if goods are exported from Canada at the same price at which they would be sold to an independent dealer or distributor, the authorities would probably accept

¹ *Supra*, paragraph 33.

² *Supra*, paragraph 43.

it as delimiting the Canadian share of the profit, otherwise the Minister would apportion the income. The above-mentioned provision would apply to non-residents who export from Canada such commodities as pulp, asbestos, lumber and other raw materials which are partially processed in Canada and shipped abroad for further processing and manufacturing.

439. In South Africa, the whole of the profits derived from sales direct to customers outside the Union, or even through agents abroad, is taxable; but if the manufacturing enterprise in the Union maintains a retail establishment in another country for the sale of its products, then only a manufacturing profit would be regarded as having arisen from Union sources, and it would be determined by valuing the output transferred to the retail branch at prevailing wholesale prices within the Union.

440. Belgium has no legislative provision attributing to the manufacture or production in Belgium a fixed quota of profits derived from the sale of goods abroad, but the administration must determine in each case the extent to which the local establishment must be considered as having realised profits. The situation in Luxemburg is similar. A criterion employed by the French administration in assessing the tax on industrial and commercial profits is that the profit allocable to the local factory is considered equal to that which the factory would earn by manufacturing for sale to other parties the goods which it makes for delivery to the foreign selling establishment.¹ In Italy, the factory is taxable on the difference between the cost of manufacture and the price at which the goods leave the factory to be placed on sale — *i.e.*, wholesale price (*prix de gros*). If necessary, the finance bureau may have recourse to a comparison with other enterprises manufacturing a similar product. In the Netherlands, the "normal manufacturing profit" is taxable. To determine the normal profit, the authorities consider the price which would have been paid to another enterprise for the same goods instead of manufacturing them itself in its own factory. They also consider the special reasons for installing a factory in the Netherlands. In Netherlands East India, the agricultural and mining enterprises not only produce raw materials, but also prepare them for the world markets. As the price is determined on the world markets, the authorities consider that the entire net profit is taxable in Netherlands East India. If the foreign enterprise produces its raw materials in Netherlands East India and subsequently uses them at its factory in another country, the world market price is used to delimit the profit allocable to Netherlands East India. As the latter country is not an industrial country strictly speaking, the question of a manufacturing profit is not of importance and, if cases arise, the profit would be apportioned according to the same principles as those previously stated as applicable to a foreign manufacturing enterprise with a local sales establishment.

441. As has been previously indicated, Austria allots under its law a minimum of two-thirds to a manufacturing plant within its territory and, in its treaties with Czechoslovakia and Hungary, shares the net profits in the ratio of two-thirds to one-third. Czechoslovakia, in its law, has adopted minimum requirements; at least one-fourth of the total net profit for the purpose of the general profits tax on individuals and two-thirds for the special tax on companies. Its treaty with Poland provides for an apportionment of income in the ratio of invested and working capital and expenses in the ratio of income. Spain would apportion the total net revenue of the foreign enterprise in the ratio of the importance of the local factory to the enterprise as a whole, and Switzerland in the ratio of the productive factors pertaining to each, reserving a *préciput* to the seat.

442. In the following countries there are no definite precepts for carrying out the general principle in their law of taxing the profit attributable to the activities of the local establishment: Denmark, Sweden, Germany, Danzig, Hungary, Estonia, Latvia, Poland, Greece, Roumania and

¹ Decision of the Conseil d'État, July 25th, 1929; *supra*, paragraph 49.

Japan. If the local accounts are inadequate, the Hungarian authorities are inclined to base the assessment on the ratio of the local pay-roll to total pay-roll. The Estonian authorities may determine the transfer price from the factory to the branch by comparison with the average market prices in Estonia, or by reference to a table of average market rates. The Greek authorities, if necessary, will make an empirical assessment by ascertaining what should be the price on a f.o.b. shipment to an independent purchaser, or by applying an appropriate rate of commission to the production cost. The Roumanian authorities state that the profit would be taxable if it appeared in the accounts.

443. The United States of America applies the same provisions in allocating the profits to the local factory of a foreign enterprise which then sells the goods abroad as it does in taxing the profits from the sale in the United States of goods which have been produced abroad — that is to say, if the goods are shipped abroad at an independent factory price, it will be taken as a measure of the American profit, otherwise recourse may be had to fractional apportionment or some other method, under Article 682 of the Regulations.

444. Under the Wisconsin income-tax and the New York State personal income-tax, if the books of the local factory do not reflect a fair manufacturing profit, the apportionment formula would probably be resorted to. Likewise the formula under the Massachusetts excise-tax and the New York franchise-tax would apportion the income of a corporation as between manufacture within their respective territories and sales outside.

445. There are three countries which, under their laws, tax the whole of the profit derived by a foreign enterprise from manufacture within and sale without : British India, the Irish Free State and Mexico. Cuba does the same in the relatively few cases occurring in its jurisdiction. The provision in the British Indian Income-Tax Act,¹ that all profits arising from a business connection in British India, such as a factory, are deemed to arise and accrue in British India and are therefore taxable there, has been interpreted by two court decisions : those of *Rogers Pyatt Shellac Company v. Secretary of State*² and of the *Commissioner of Income-Tax, Burma v. Steel Brothers and Company, Limited*.³ In practice, this provision has, however, been somewhat tempered. It may be recalled that, in one case, an American corporation was held taxable because it operated a factory in the United Provinces, the products of which were exported and sold abroad, and also because it purchased, at a branch office in Calcutta, gum, shellac and other products for export and sale abroad. One of the judges indicated that the profits or gains attributable to a business connection in British India may be calculated by fixing a reasonable percentage of the turnover or by one of the other methods indicated in Rule 33 of the Income-Tax Rules.⁴ In the other case, where a non-resident British company worked up rice, cotton and other products in India for sale abroad and also purchased certain products and sold them without transformation, the court held that no distinction could be drawn for income-tax purposes between profits on products which the taxpayer had processed in India and profits on products purchased in India and exported in the same form. Although the law provides that all income derived from such business connection in British India shall be deemed to have accrued or arisen there, the court held that there should be excluded from assessment a reasonable commission agent's commission on the sale of the products in London. These decisions are carried out fairly closely in the practice, which varies somewhat from province to province with regard to fixing a percentage representing

¹ Section 42 (1) ; *supra*, paragraph 35.

² 1 I. T. C. 363 ; *supra*, paragraph 36.

³ 2 I. T. C. 119 ; *supra*, paragraph 37.

⁴ *Supra*, paragraph 36.

the part of the total turnover that represents the profit attributable to manufacture, etc., in British India, and in allowing the deduction for a sales commission.

446. The Irish Free State law allows no room for leniency. Under it, the whole of the profit derived by foreign enterprise from the sale of goods which it has manufactured or partly manufactured in the Free State is taxable, regardless of where the sale is effected. ¹

447. Although the whole of the profit derived from manufacture in Mexico and sale abroad is taxable in Mexico if goods have been invoiced from the factory to the foreign sales branch at a fair price, in practice the invoice price may be taken as indicative of the gross receipts of the local factory. This price is not conclusive, however, and the authorities may require full information as to the eventual sale price of the goods exported in order to calculate the total net profit allocable to Mexico. Cuba likewise subjects to its tax the total profit derived by the few enterprises which produce minerals, sugar or other raw products in Cuba and sell them abroad.

PROCESSING ESTABLISHMENTS.

448. If a foreign enterprise produces goods in one country, processes them at an establishment in a second and ships them to an establishment in a third country for further processing or sale, as a general rule, the authorities of the second State impute a profit to the local processing establishment. The rules described above in connection with manufacturing establishments are generally applied to processing establishments. This is true in the United Kingdom, the Irish Free State, British India, Canada, Belgium, Luxemburg, France, Italy, the Netherlands, Netherlands East India, Spain, Switzerland, Denmark, Germany, Danzig, Czechoslovakia, Hungary, Estonia, Latvia, Poland, Greece, Roumania, Japan, Mexico, the United States, Massachusetts, New York and Wisconsin.

449. The Austrian law does not prescribe a fraction as in the case of manufacture, and the authorities must therefore estimate the share of the profits allocable. No principles have been evolved in practice, but the estimate may be facilitated by a comparison between the cost of the processing operations in Austria and the total cost of production. The treaties with Czechoslovakia and Hungary do not contain any provision on this subject. The Cuban authorities do not know of a case within their jurisdiction, but feel that any profit accruing to the local processing establishment should be taxed. Most of the countries indicate that they have but few cases of this sort, and therefore have not had occasion to develop any definite rules.

450. In South Africa, however, no profit is ascribed to processing establishments, because their operations are regarded as too remote from the sale of the goods to justify any allocation of the profits realised.

BUYING ESTABLISHMENTS.

451. If a foreign enterprise buys goods through an independent commission agent or broker in a given country, with a view to manufacturing and/or selling elsewhere, in general no attempt is made to tax it on a presumed purchasing profit. About the only exception to this rule is in the Mexican law. No attempt is made to compute a buying profit as such, but agents, commission agents and representatives of foreign enterprises who purchase articles for exportation must pay a tax of 0.5 per cent of the total amount of their purchases. ² Many countries refrain from imposing tax in respect of purchasing within their territory, as they consider it undesirable to impose any

¹ *Supra*, paragraph 34.

² Law of March 31st, 1925, as amended, Article 9.

such obstacle to the buying of their products by non-residents. Thus, in 1860, it was held in the United Kingdom that mere buying there did not constitute trading, the court declaring, *inter alia*: "It would be most impolitic thus to tax those who come here as customers".¹ The United States Revenue Act specifically provides, in Section 119 (*e*), that income derived from the purchase of personal property within the United States and its sale without the United States shall be allocated entirely to the place of sale — that is, to the country in which the contract of sale was concluded. Other countries which do not tax the mere purchase of raw materials or merchandise for exportation by the foreign enterprise are: Canada, South Africa, Greece, Roumania (unless a profit appears in the local books), Cuba, Japan, Wisconsin and the New York personal income-tax administration. Because of their principle of imposing tax liability on the grounds of maintaining a permanent establishment in their territory, a number of European countries consider that a local buying establishment is taxable, but admit the difficulty in practice of determining its true liability. Thus, the authorities of the following countries do not indicate how this principle may be carried out: Germany, Danzig, Hungary, Estonia, Latvia and Poland. Denmark and Luxemburg are apparently not concerned with this problem. Belgium requires that a local buying establishment must keep special accounts showing its local operations, and it may be taxed either on their basis or on an empirical basis. In connection with the French tax on industrial and commercial profits, it has been held² that, in the case of a company with its head office abroad which had in France an office under special management for the purpose of buying goods for resale abroad, the operation of this office in itself constituted a commercial enterprise, and the profit realised was due in part to the conditions of purchase, even though payment was made abroad. The profit taxable corresponds to the profit which the buying establishment would make if it carried out the same operations for third parties — *e.g.*, a purchasing commission. The Swedish authorities hold the same view.

452. The Netherlands considers that a buying establishment should be taxable on presumed profits, which will vary with the case. For example, a percentage representing net profit may be applied to the purchase price of each lot of merchandise. In applying their method of fractional apportionment, the Swiss cantons may allocate a profit to a local purchasing establishment in the ratio of turnover in a purely commercial enterprise, or in the ratio of the productive factors of an industrial enterprise, reserving a *préciput* to the seat of management. As has been previously indicated, Austrian law reserves a minimum of one-half of the profits where the foreign enterprise has a local establishment purchasing for sale abroad, and, under its treaties with Czechoslovakia and Hungary, the profits are divided by half. If the local establishment purchases raw material for manufacture abroad, it is not subject to any special provision in the law or treaties. In practice, the profits of the local establishment may be computed on the basis of a normal purchasing commission and a similar assessment may be made under the treaties. In Czechoslovakia, at least one-fourth of the net profit may be ascribed to the local establishment under the general profits tax on individuals, and one-half under the special company tax.

453. It is in countries which are primarily productive of raw materials that serious efforts have been made to tax the local establishments of foreign enterprises which maintain a large organisation for not only the purchase of raw materials from the farmers, but also sorting, packing and preparing for export. Thus, in Italy, there have been a few cases in which the principle of taxing a buying organisation has been upheld, the taxable income being that which corresponds to the saving realised by the enterprise in relation to the current purchase price for acquiring in Italy the product ready for exportation. It is the Italian theory that, through having a permanent establishment, the foreign enterprise is able to purchase the goods at a lower figure than it would

¹ *Sulley v. Attorney-General*, 2 T.C. 149; 5 H. and N. 711; *supra*, paragraph 26.

² Decision of Conseil d'Etat, February 14th, 1930; *supra*, paragraph 49.

in the Italian market. For example, if a foreign company has in Italy an establishment for the purpose of collecting eggs from peasants in order to export them, the profit is the difference between the price of the eggs collected by the establishment, together with the cost of sorting and packing them for export, and the price (*prix de gros*) of eggs sold by wholesale merchants in their warehouses. Very often, the buying establishment sorts, treats and otherwise prepares the object for sale, and it is to these operations that a profit should be ascribed. The Swedish view is essentially the same as regards the purchase of standing trees, or if purchases are effected regularly.

454. In Spain, there are many cases of buying organisations, and, in principle, the transaction of purchase and sale is considered as a whole and an attempt is made to discover the comparative importance in commercial practice of each of these operations. Generally speaking, according to information acquired by Spanish fiscal experts, in the case of the majority of goods, purchase is less important than sale. In fact, commercial practice has led to the fixing of definite rates of commission which the jury of experts applies in ordinary cases. There are exceptions, notably in the case of enterprises which buy perfumes of Spanish wild mountain flowers, the operation of purchase being considered much more important than that of sale, because of the considerable organisation and expensive system of control entailed, whereas sale is a simple commercial transaction. As it has been previously indicated, in discussing foreign enterprises manufacturing in British India, those which purchase goods in British India through an establishment there are considered to have a business connection in British India which entails liability to tax on the whole of the profit derived from the sale of the goods purchased through it.¹ The principal reasons given for taxing non-residents with purchasing establishments are: (1) it is considered that a part of the eventual profit is due to skill in purchasing; and (2) it is felt that non-residents who profit from purchasing and exporting British India products should bear some tax.² The cultivator or receiver of rent in kind who sells raw produce (e.g., tea, cotton, paddy), or the landowner who sells timber grown on his own land to the non-resident, pays no tax on such "agricultural income", provided the land itself is subject to local taxes. The decision in the case of Steel Brothers and Company, Limited,³ held taxable all profit, less a reasonable sales commission allocable to the London sales office of the enterprise, and, in carrying out this decision, the Burma authorities indicated that this commission may vary with the nature of the goods. In practice, the authorities may endeavour to restrict the tax to what might be considered appropriate to the local activities; thus the Bombay authorities estimated that, in the case of a non-resident firm which purchased and cured pearls in Bombay and sold them abroad, the profit attributable to the local activities was from 3 to 5 per cent of the purchase price. If, however, accounts showing the total net profit were submitted, the Tax Commissioner would assume one-fourth or one-third to be Indian profit. In difficult cases, the income-tax officer may come to an understanding with the taxpayer concerning the percentage to be applied to receipts from sales abroad. This percentage is applied to receipts from sales during the preceding financial year, rather than to receipts from particular shipments. It is presumed that the purchased goods which are exported are sold at a profit, but no assessment would be made in respect of goods unsold or sold at a loss, provided the taxpayer shows that such is the case.

455. The Netherlands East Indian authorities have occasion to assess several foreign enterprises whose activities in their territory are restricted exclusively to buying and preparing raw materials to export for manufacture or retail sale by the principal establishment of the enterprise abroad. In the absence of more accurate information concerning the wholesale buying of raw materials for a world concern, the authorities consider it sufficient to treat as East Indian profit an amount equal to the usual commission on the purchases that would be paid to an independent purchasing agent, especially when the buying transactions were effected by a subsidiary

¹ Indian Income-Tax Act (XI of 1922), Section 42(1); *supra*, paragraph 445.

² "Taxation of Foreign and National Enterprises", Vol. III, page 42, paragraph 117.

³ *Supra*, paragraph 37.

company substantially in the position of a commission agent. In such cases, no assessment would be made on the parent company itself. The authorities admit that this method may not be entirely satisfactory, but they must employ it in view of the difficulties in obtaining a true insight into the total profit of the foreign concern. If a foreign enterprise specialises in buying the products of small native farmers, very often an extensive buying organisation is required, entailing intricate financial transactions. In these cases, the buying is such an important factor in producing profits and the selling abroad is, as a rule, such a very simple transaction that more than half is considered to be East Indian profits. This percentage varies with the peculiarities of the case. The Netherlands East Indian authorities cite as an example the business of buying pepper. A few foreign dealers not only buy pepper in the local market in Batavia, but also have their local buying agents in different parts of South Sumatra who, by giving advances to local growers or smaller buying agents, ensure themselves of the quantity of pepper needed for their trade. Such a buying organisation involves considerable risk and expenditure, requires a knowledge of the country, the people and the local markets, and is obviously a much more important factor in the enterprise than the office in London or New York, which sells the pepper on the produce exchange.

456. Difficulties arise especially when the enterprise does not confine itself to real buying and selling of products, but goes in for speculative contracts. The verification of the allocation of profits as made by the taxpayers themselves (for instance, for the purpose of calculating a bonus to the East Indian manager or staff) is exceedingly difficult in those cases, because it is generally impossible to trace the results of certain transactions, on account of the impossibility of putting buying transactions over against corresponding selling transactions. As a last resort, the East Indian profit will have to be computed by means of valuation.

457. As a general rule, we may say that, for foreign concerns which carry on wholesale buying in this country of products of industries, which products are again sold wholesale abroad, the profits are considered to have been made in the ratio of 50 per cent within and 50 per cent outside Netherlands East India. This method of apportionment is applied to the total net profit derived from the transactions carried on partly within and partly without the country, without taking cognisance of any specific commissions or charges made by establishments abroad against the buying establishment within Netherlands East India as compensation for selling, management or other services rendered to it. The application of this method is, of course, subject to modifications, in order to take into account the circumstances of the particular enterprise.

458. When the products have to undergo some sort of manufacturing process in Netherlands East India, the nature of this process will be the deciding factor in determining whether more than 50 per cent is to be allocated to this country. Thus, where a foreign company purchased, cured and packed tobacco in East India and sold it wholesale in Europe, it was held that two-thirds should be allotted to East India, the remaining one-third being excluded from the assessment, because of representing the profit attributable to the European establishment, which principally managed the buying, all the selling and the general financing, and kept the books.¹

459. On the other hand, it will be inadmissible to fix the East Indian profit at half of the net results of the foreign enterprise if the latter subjects these products, bought wholesale, to an additional manufacturing process in the foreign country, or sells them to the public at its own retail establishments. In these cases a certain part of the profits must be allocated either to the manufacturing process or to the retail sales.

¹ *Supra*, paragraph 55.

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¹ *Supra*, paragraph 55.

460. The authorities in the State of Wisconsin are also of the opinion that, when buying is accompanied with processing, some profit should be imputed to that end of the business. They cite as an example a company in the eastern part of the United States which purchases tobacco in Wisconsin and processes and stores it before shipping it from the State. It should be pointed out that, when the purchasing of material is thus accompanied by processing or improvement of some sort, the activity generally comes under the rules applied to manufacturing and processing establishments described above.

RESEARCH OR STATISTICAL ESTABLISHMENTS, DISPLAY ROOMS, ETC.

461. If a foreign enterprise has an establishment in a given State which does not directly engage in any profit-making transactions, but renders services to the enterprise which contribute indirectly to the realisation of profits — *e.g.*, a statistical bureau, a research laboratory or a display room — the practice in the majority of countries is not to ascribe any profits to the establishment as such. Many of them point out that, if there is in the country a sales establishment or a factory, any profits due indirectly to the existence of the above-mentioned establishment should appear in the books of the factory or the sales office.

462. In the Anglo-Saxon group of countries, the maintenance of such an establishment is not considered as trading or constituting a source of income under the law. Within the States of the United States, the question of liability depends upon whether or not the maintenance of such an establishment constitutes doing business, and it is difficult to say whether or not the maintenance of such an establishment would give rise to liability. In any event, under the New York corporate franchise-tax or the Massachusetts excise-tax, the maintenance of such an establishment might entail liability.

463. In the European group of countries, which base liability primarily upon the maintenance of an establishment, the foreign enterprise might be liable in respect of one of the establishments indicated above, although no tax would be assessed because of no income actually accruing to it. Thus, in Belgium, the administration decided that a foreign company which maintained a supervisory bureau in Belgium would be regarded as having an establishment there, although it might not be taxed if its special accounts showing no profits were accepted by the authorities. Liability to the French industrial and commercial profits tax depends on circumstances. If the sole purpose of the local establishment is to furnish the enterprise with statistics or information regarding market demand, possible outlets for goods, prices charged and sales made in France by competing enterprises, the amount of credit that might be allowed to possible buyers, etc., it would be liable to the industrial and commercial profits tax on a profit corresponding to that which would be earned by an independent agency undertaking to furnish similar information to third parties. A showroom in France must necessarily have there an agent who, if he does not make sales direct, gives information to customers and receives orders for conveyance to the foreign enterprise. The agent or employee, being in charge of the premises bearing the name of the firm, must be regarded as a special manager, and the foreign enterprise must therefore be deemed to have in France an establishment entailing liability to the tax on industrial and commercial profits.

464. In Italy also, the liability to tax depends upon the facts of each case. An examination of the organisation of the establishment, its method of operation, the effective extent of its services in regard to the productive activity of the foreign enterprise, etc., is necessary before tax liability can be ascertained. There would be no liability in the case of an establishment for the sole purpose of collecting statistics, as such an organisation would be incapable of earning income. If there is as well a sales organisation, the receipts from sales would include the income earned

by the statistical bureau, but it would be impossible to determine the latter separately. In the case of a showroom, there would be no liability to tax if no orders were taken there, but, in the event that the taking of orders is a part of its business, the establishment would be liable to tax on the profits resulting from such sales.

465. The Netherlands authorities predicate liability upon the fact whether the enterprise, in the absence of such an establishment, would have to employ the services of third parties. For example, a publicity bureau would probably entail liability on the amount corresponding to the expenses saved to the enterprise by reason of the existence of the local establishment. The Spanish authorities say that they would tax such an establishment on the basis of its relative importance in the enterprise as a whole. The same is true in Switzerland. Denmark does not have any rule for this case. Sweden, Germany, Danzig, Austria, Czechoslovakia, and Hungary hold such an establishment taxable in principle, but have no rules for its assessment. Latvia would not tax such an establishment unless the profit is realised there, and the same is true in Poland. No tax would be incurred in respect of such an establishment in Greece, Roumania, Japan, Cuba and Mexico.

CHAPTER VIII.

FOREIGN BANKING ENTERPRISES.

466. Banking enterprises present relatively few problems of allocation ; in the first place, because of the limited number of those which are carried on internationally, and, in the second place, because of the nature of their transactions. Certain countries prohibit foreign banks from opening establishments within their territory — for example, Canada and Estonia, and the American States : Massachusetts; Wisconsin and New York. The last-mentioned permits the existence of branches of foreign financial institutions, provided they do not engage in banking in the strict sense of the term. Other States subject foreign banks to a rigid control, such as Japan and Mexico. As the primary purpose of establishing branches abroad is to have direct contact with other important money markets in the world, to finance foreign trade or to finance the exploitation of resources in possessions beyond the seas, owning foreign branches tends to be limited further to the large banks of such countries as the United Kingdom, France, the Netherlands and the United States. Banks which formerly had branches in the various provinces of the Austro-Hungarian Empire present problems of allocation because of the frontiers that now divide them.

467. In general, the great majority of countries which permit branches of foreign banks to be established in their territory subject them to the same fiscal regime as industrial and commercial undertakings. That is to say, the tax is assessed upon a declaration supported by the accounts of the local establishment, subject of course to verification, and, if necessary, by reference to the balance-sheet, profit-and-loss statement and other useful data which are kept at the head office abroad. If the accounts are insufficient, the administration may resort to an assessment on an empirical or a fractional basis. Such is the general regime for foreign banks in the United Kingdom, the Irish Free State, British India, Belgium, Luxemburg, France,¹ Italy, the Netherlands, Netherlands East India, Denmark, Germany, Danzig, Austria, Czechoslovakia, Hungary, Latvia, Poland, Greece and Roumania. In Japan, local branches can be assessed with comparative ease on the basis of their separate accounts, because of the strict requirements for

¹ This is true of the French tax on industrial and commercial profits. The tax on income from securities, however, is levied on a taxable quota of the dividends and interest paid by the foreign company at its seat abroad. For banks whose French business consists merely in making loans to private persons or companies, the taxable quota is fixed by comparison between the amount of loans in France and the value of the company's assets. The amount of the loans is shown by a detailed return of the debts due in France with the names of the debtors. For banks which set up a branch or agencies in France to do every kind of business belonging to the special nature of such companies, the taxable quota is determined, as a general rule, by comparing the working capital allotted to the French branch with the company's entire capital. If there is no such working capital, or if it is not commensurate with the amount of business done, the criterion taken is the proportion between the French receipts and the total receipts. " Taxation of Foreign and National Enterprises ", Vol. I, page 89.

the keeping of books and the submission of annual reports. Even if the local accounts are not satisfactory from the viewpoint of assessment, the fiscal authorities state that the determination of income is not difficult, except in respect of the allocation of certain items of expenditure which will be discussed below.

468. In Cuba, the branches of foreign banks are treated as if they were separate enterprises. The Cuban Supreme Court has held that, for the purposes of the income tax, the parent and branch can be considered as distinct entities. If, however, the parent makes an advance to the branch, it is not necessary to make a contract, but it is sufficient to enter the loan in the books together with the interest charged.¹ In other cases, the tax administration has allowed the deduction of a part of the interest on general indebtedness, which corresponded to the amount advanced to the branch.

469. Likewise in Mexico, assessment on the basis of separate accounting is the rule, because of the requirements of the Mexican banking law, and of the verification by official bank examiners, whose determination of income is accepted by the tax authorities. Foreign banks generally allot to their Mexican branches a sufficient capital, and the branch is conducted and its books are maintained as if it were an independent bank. The branch charges the foreign parent for collection or for other services rendered to it. Interest paid to the parent on advances is subject to tax by withholding at source. The United States authorities also tax local branches of foreign financial institutions on the basis of their accounts, subject to adjustment if necessary.

470. Spain and the Swiss cantons, on the other hand, use fractional apportionment in taxing foreign banks, the former having regulated the application of this method in treaties.² The State of New York subjects foreign financial institutions to a franchise-tax based on net income.

471. The principal reason for the widespread use of separate accounting in taxing branches of foreign banks is that the very nature of their activities permits of a definite allocation of most of their items of income and expenditure. In general, the activities of international banking enterprises consist in receiving deposits, making loans, discounting commercial paper, effecting exchange and arbitrage transactions, purchasing and selling bonds and other high-class securities, renting office space in buildings which they own or lease, and renting safety deposit boxes. Obviously, most of these principal sources of income can be readily ascribed to a definite country. Similarly, most of the expenditures of a banking enterprise are readily allocable to a particular country, such as rents on business property, repairs, interest on deposits, taxes, losses, bad debts, depreciation, and salaries and wages to officials and employees occupied with local business. There are, however, other items which present questions of apportionment, such as the salaries paid to the principal executive officers and other items of general overhead, as well as various other expenses and losses.

472. In respect of items of income, some of the difficulties encountered are those of determining the rate of interest that should be charged, if any, when the head office or one branch makes advances to another branch, in order to provide a second branch with funds to be lent. Should a distinction be made between funds advanced out of the bank's capital or out of deposits? If a large bank has its principal establishment in one country and a branch in a second, often a depositor will keep his account with the principal establishment, yet when travelling, draw cheques at the foreign branch or otherwise make use of its services, all of which entails expense for the branch not covered

¹ Supreme Court decision, No. 85, of June 21st, 1930.

² *Infra*, paragraph 486.

by compensation of any kind. The principal establishment profits from the prestige of having a branch in the second country and its increased capacity for service, yet the branch establishment does not show in its books any reward for this phase of its income-producing capacity. On the contrary, the branch, because of the prestige of the bank's name, draws increased deposits which may flow to other branch establishments outside the country to be used in loans to outsiders. The branch has to pay interest to its depositors, but, unless a proper interest rate is charged to the other branch establishment which receives the advance, the first-mentioned branch will show in its books only items of expense and no income. If two establishments are involved in the purchase and sale of commercial paper or bills of exchange or securities, or if an establishment in one country discounts a bill of exchange and forwards it to an establishment in a second country for collection, questions arise as to the allocation of the income derived.

473. It is because of these rather intangible interrelated factors, and also these interlocking transactions, that some of the United Kingdom tax inspectors have been inclined, when the separate accounts of the London branch of a foreign bank have appeared to them inadequate, to assess the United Kingdom profits at the same proportion of the total profits of the foreign bank as the United Kingdom assets bear to total assets. This method involves difficulties in ascertaining which are United Kingdom assets and which are foreign assets, but these questions are usually capable of adjustment after negotiation. The practice is the same in the Irish Free State.

474. In South Africa two of the foreign banking enterprises operating in the Union are assessed on the basis of the local accounts of their branches, a third foreign bank is taxed on the assets basis. In the last-mentioned case the taxable income or assessed loss is the sum which bears the same proportion to the total net profit or loss from all sources (computed in accordance with the Union Income Tax Act) as the assets of the enterprise in the Union bear to the total assets of the enterprise. The authorities consider that this fractionnal method of assessment produces a less inaccurate result in the case of banks having their assets distributed in the countries in which they operate.

475. The British Indian income-tax authorities state, however, that the local branches of foreign banks frequently work on credits provided by the head office, and there are very little assets in British India other than these credits. Consequently, if profits were allocated with reference to assets, evasion would be simple if the assessment were made on a certain date — for example, the closing date of the accounting year — as manipulation would be easy, whereas a computation with reference to the varying position of assets from day to day would entail enormous work without any commensurate advantage. The British Indian authorities usually tax on the basis of the separate accounts of the local branch. If no such accounts are maintained, they usually work out an account for the local branch, basing it on the gross profit apportioned to that branch in the ratio of its receipts to total receipts, and deducting local expenditure, including proved local losses, salaries and other costs of the local establishment and a *pro rata* share of the general management charges at the head office abroad and interest on general indebtedness, this share being fixed in the ratio of receipts. Inasmuch as only profits accruing or received in British India are taxable, only expenses incurred in the earning of such profits are deductible. No deduction is allowed for interest on capital or reserves allocable to the Indian branch. Interest on deposits and borrowings are deductible only to the extent that such deposits are required to make loans in British India and to provide for other assets in that country necessary for the banking business, like cash and buildings. The interest charged *pro forma* on transactions between the head office and the branches is scrutinised with reference to market rates from day to day. Profits from discounting international bills are not allocated between the two ends in any definite manner, and the accounts of the bank in this respect are generally accepted without challenge.

476. The Netherlands authorities have evolved certain guiding rules for the branches of foreign banks (other than exempted foreign or colonial central banks of issue) :

(1) Profits from purchasing, selling and other transactions in commercial paper and securities (*effets, titres et valeurs*) by the bank for its own account are allocable for tax purposes to the branch or establishment which took the initiative in the profitable transaction.

(2) Income from commercial paper and securities is attributed to the establishment which included these sources in its assets on the date of its inventory, provided that establishment is qualified to sell them.

(3) Commissions charged on transactions for the account of third parties must be considered as a part of the profit of the country where the transaction was effected for which the commission was charged.

(4) Interest and other income from loans and advances of capital must be considered as realised in the country where the funds have been invested or lent, and the losses suffered on investments and loans must be considered as having been suffered in the country where the loans were made.

(5) As regards interest paid by the branch, only interest paid to outsiders is deductible, and a branch has no right to deduct interest owed to another part of the enterprise.

477. A difficult question is that of determining what part of the funds used in loans and investments by a branch comes from funds borrowed from outsiders or from amounts advanced by another part of the same enterprise. The authorities distinguish between two cases. The first is that of an establishment which receives directly from its depositors or outsiders sufficient funds and capital for its purpose without using the capital of the enterprise itself or advances obtained from other establishments. In this case, the interest deductible is that paid on the total debts to outsiders attributable to the establishment itself. The second case is that of an establishment which does not itself receive sufficient funds from outsiders and therefore uses a part of the capital of the enterprise or capital advanced from other establishments of the same enterprise. Interest on the capital of the enterprise is not deductible. Advances from other establishments include part of the liabilities of the enterprise to third parties, and interest attributable to that part is deductible. The administration, however, considers that it is impossible to determine directly the deductible amount when there are more than two establishments, and deems that the enterprise's own working funds are employed in all establishments where the amount received from outsiders is insufficient for the needs of the local establishment. Consequently, the administration allows, to a given establishment, the same proportion of interest on funds received from other establishments of the enterprise as the amount of the funds received from outsiders by all establishments in the same situation bears to the total of such funds and of the capital funds employed by the enterprise.

478. If the interest paid by the local branch is deductible only to the extent of its effective amount — *i.e.*, at the rate in force in the country where the funds were borrowed — there is occasion to increase the rate by reason of the overhead incurred in the country where the amounts were borrowed, because the overhead (rents, salaries, etc.) incurred in that country have contributed to obtaining the resources placed at the disposal of the enterprise. Nevertheless, it may occur that income from interest on investments may not be entirely attributed to the country where these investments were effected. This takes place when the rate of interest from which the funds were obtained to be used in the investments is inferior to that in the country of investment. It also takes place when the bank has been able to borrow in another country money at a rate lower than the normal rate, and assures certain advantages or renders certain services to the country from which

the funds come ; the gains derived from being able to borrow at a more advantageous rate than the normal is attributed, after deducting the expenses relating to the services rendered, to the country from which the funds came.

479. The Netherlands East Indian authorities state that, in assessing on the basis of the separate accounts of local branches of foreign banks, they have little trouble in allocating items of gross income, but they incur great difficulties in determining deductible interest. The gross income of a Netherlands East Indian branch usually includes income from lending to individuals or companies in the country, discounting bills, effecting collections or rendering other services, as well as rents from properties situated and profits from business conducted in Netherlands East India. As in the mother country no deduction is allowed for interest on the bank's own capital, whether that capital is used by the head office or by the local branch or elsewhere to compute the deductible interest in respect of deposits, the administration has developed a theory that money from deposits becomes mingled with the capital of the bank itself and therefore loses its character. The combined funds flow from one establishment to another in accordance with the need for them in making loans to outsiders. When an establishment advances money to another, it charges interest, but, for tax purposes, only interest attributable to deposits is deductible. As it is impossible to ascertain how much of every advance is out of deposits and how much is out of capital, the authorities assume that the proportion of deposits to capital is the same in every part of the enterprise. Consequently, they allow as a deduction from the East Indian profits that part of the interest paid to local depositors which corresponds to the ratio of total deposits to total capital. Taxpayers often object to this theory on the grounds that the amounts deposited in the Netherlands East Indian branch often exceed in fact the amounts loaned by the branch ; therefore the above-described limitation should not be applied to the interest actually paid by the local branch to its depositors. To such arguments the administration replies that it is impossible to say what income from loans is earned solely by the use of deposits. Amounts deposited become mingled with the capital. Depositors will not put their money in a bank unless it has sufficient capital to assure them of the safe return of their money when wanted. Consequently, it is presumed that earnings should be attributed to capital and deposits in the ratio of their respective amounts. This ratio is the same in all the branches of the business (with the possible exception of banks of issue and banks working in countries with abnormally high or low rates of interest). The ratio between the capital and deposits of the Netherlands East Indian branch is therefore presumed by the authorities to be the same as the proportion between the company's entire capital and deposits, regardless of the amount of capital allotted to the local branch in the books of the parent bank, and this proportion limits the amount of interest on deposits that may be deducted. The administration has observed that the taxpayers' method of computing the so-called East Indian capital is often extremely arbitrary.

480. It is of interest to note that, if the head office abroad of a foreign bank lends money to the head office abroad of a foreign company for use in its business or exploitation in Netherlands East India, the interest is generally allotted by the tax authorities to the bank's branch in Netherlands East India, even though the bank itself may not do so.

481. The Greek administration handles the question of interest in accordance with very simple rules. If the seat abroad of the foreign bank advances funds to the local branch, such interest is exempt from tax by a special legislative provision, and the branch has the right to deduct the interest charged in computing its taxable net income, provided : (1) the interest rate is not higher than the official discount rate in the country from which the funds came ; (2) the interest does not include interest on capital invested in the branch in Greece as its own capital. This branch capital is determined by applying to the total capital and resources of the company the ratio between the gross income of the branch and the total gross income of the entire enterprise. If the Greek branch

exports capital by advances to other establishments of the bank, the administration verifies the interest which must be included in the branch's income and considers that it should be evaluated in accordance with the official discount rate in Greece.

482. The Japanese authorities have likewise enunciated in practice a simple rule regarding deductible interest. In principle, interest charged by the foreign bank on advances to its branch is deductible to the extent that the advance is not made out of capital and provided the rate is reasonable. In practice, where it is difficult to ascertain how much of the advance consists of capital, a reasonable bank rate of interest may be deducted.

483. The question as to how much of the overhead of the central management abroad should be allocated to the local branch is also handled by the Japanese authorities in accordance with a simple rule — *i.e.*, that of apportioning it in the ratio of gross income arising within the country to the total gross income of the enterprise.

484. This same method of apportionment in regard to general overhead is followed by the United States revenue authorities.¹ In dealing with local branches of foreign financial institutions, the revenue authorities apply the general provisions for allocation contained in Section 119 of the Revenue Act. They first allocate the items of income or expense that are attributable to a definite source within or without the United States and then apportion the expenses, including general overhead, losses and other deductions which cannot be definitely allocated. They find in practice that most items of income are definitely allocable to a source which is clearly within or without the United States. Thus individual items of interest and dividends can be readily allocated to their source; but, if they are lumped in the accounts regardless of their source, some arbitrary method of allocation is necessary. It is impracticable to apply in the case of banks, the percentage of turnover method, because banks, properly speaking, have no turnover. They therefore use some method which appears appropriate in a given case. Bad debts are, as a rule, allocated to the place where the loan agreement was contracted. The place where the contract was closed may also serve as a test in other international transactions. It is in the allocation of general overhead of the central management that the principal difficulties arise, but the procedure is first to deal with items that can be attributed to a particular source within or without the United States, and then to apportion the balance in the ratio of gross income.

485. Where an assessment cannot be made on the basis of accounts, some countries resort to empirical assessments — for example, the Greek authorities may assess profits on the basis of a comparison with those made by Greek banks — and certain authorities may deem it necessary to resort to fractional apportionment. In the latter case, the factors preferred vary from country to country. It has been indicated that the British authorities are inclined to fractional apportionment in the ratio of assets. The German authorities express a predilection for the ratio of gross receipts. Although Austria prefers the method of separate accounts, in its treaties with Czechoslovakia and Hungary provision is made for apportioning the total net income of banks in the ratio of salaries and wages of the employees in the establishments in each country.

486. When the Spanish profits jury fixes the percentage applicable to the net income of banks not subject to the provisions of a treaty, it considers in the first place the degree of economic independence possessed by the branch. If it carries out its active operations by means of the financial resources derived from deposits in Spain, the real profits are taken as a basis, provided the profits made by the undertaking as a whole are still greater. If the branch does not possess

¹ Article 680 of Regulations 77, concerning the Revenue Act of 1932.

real economic independence, the jury makes a special study of the principles according to which the Spanish establishment is managed, the method applied depending entirely upon the conclusions reached by that study. If the bank is one using funds obtained in Spain in its operations in other countries, then the estimate is based upon its passive operations: if the branch is mainly engaged in using in Spain capital received from other countries, the estimate is based on the value of its loans. Generally, the final estimate lies somewhere between these two extremes. The taxation of banks has been regulated by treaties which Spain has concluded with the United Kingdom, Italy and France. In the treaty with the United Kingdom, the maximum comparative ratio is fixed by the relation between the deposit and current accounts of the branch and those of the bank as a whole. The treaty with Italy imposes a similar restriction. The treaty with France is much more elastic in this respect, and it would be possible to make a more accurate apportionment on this basis if agreement could be reached as to the meaning of most-favoured-nation treatment which is assured in all three treaties.¹ In a very few instances, when assessing banks not under the treaty regime which do not maintain satisfactory accounts, the authorities have attempted to make an assessment on an empirical basis. In one instance, the jury tried to estimate the probable profits of the branch in question by comparison with Spanish establishments of the same kind. Such a strong opposition to this method was manifested on the jury that it was never employed again.

487. The Swiss cantons of Basle Urban, Geneva and Zurich, in assessing the local branches of foreign banks, follow the same procedure as that used in inter-cantonal cases. In apportioning the total net income of the bank, a *préciput* is allotted to the jurisdiction of the seat which may vary in proportion to the importance of the centre of direction. The balance of the income is allotted to the various jurisdictions in the ratio of the profits shown in the separate accounts of each establishment, presupposing that the branches operate as if they were independent. In Sweden banking enterprises are taxed in each commune on a fraction of the total net income fixed by taking into account the deposits and loans of the local branch.

488. A foreign financial corporation which is subject to the New York State franchise-tax is required to report as net income from business carried on in New York State that proportion of its total net income from all sources which its gross income from business carried on in New York State bears to its total gross income from business carried on within and without the State. The tax commission is vested with broad discretionary powers in effecting the apportionment, and, if it is of the opinion that the branch, agency or subsidiary corporation within New York keeps an independent set of records accurately reflecting its gross and net income from business carried on within the State, such records will be accepted for the purpose of computing net income. If the books of the New York branch or agency are accepted as a basis for determining net income, the interest charged on a debt of the head office is sometimes taken into consideration by apportioning to the New York office a proportion of the interest paid by the head office, which is usually based on the ratio between the average assets employed within the State and those employed outside. The taxpayer may also be allowed a deduction for that part of the general overhead which can be shown to have a connection with income from business carried on both within and without the State, the deductible amount being measured by the ratio between the gross income or gross assets allocable to the State and those allocable outside.

¹ "Taxation of Foreign and National Enterprises", Vol. I, page 155. Agreement between the United Kingdom and Spain (1924), Article 5(a). "Collection of International Agreements and Internal Legal Provisions for the Prevention of Double Taxation and Fiscal Evasion", League of Nations, document C.345.M.102.1928.II, page 113; Arrangement between France and Spain (1926), Article 2(a), *ibid.*, page 118; Agreement between Spain and Italy, Article 4(a), *ibid.*, Supplement No. 1 (1929), page 18.

CHAPTER IX.

FOREIGN ENTERPRISES PRESENTING FEW ALLOCATION PROBLEMS.

INTRODUCTION.

489. As regards enterprises other than those engaged in industry, commerce or banking, tax administrations report practically no problems in allocation. This is due chiefly to the fact that a comparatively small number of them operate internationally. As a general rule, insurance companies and enterprises in the nature of public utilities (transport, power and light, telegraph and telephone enterprises) are subject to special restrictions imposed by law or the terms of a concession. Maritime shipping profits are almost universally subject to the regime of reciprocal exemption. The existence of world prices for products of mining enterprises affords in general a solution to this problem. The methods of dealing with the few cases that may arise are briefly described.

INSURANCE ENTERPRISES.

490. In many countries, insurance enterprises are the subject of special provisions in the tax laws, notably in the United Kingdom, the Irish Free State, British India, Canada, South Africa, Belgium, France, the Netherlands, Netherlands East India, Sweden, Japan, Cuba, Mexico and the United States of America. It is difficult to make any broad generalisation, other than that the tendency is in countries with a more developed tax legislation to distinguish between life insurance companies and those selling other types of insurance. Whereas the local branch of a foreign company selling life insurance is frequently assessed by applying the ratio of premiums, the local branch of a foreign company selling fire, marine and other types of insurance is frequently assimilated in a large measure to a commercial undertaking and taxed on the basis of its separate accounts. Thus, under the law of the United Kingdom and the Irish Free State, while a fire insurance company is generally assessed on the basis of its separate accounts, the United Kingdom establishment of a foreign life insurance company is normally charged on such a proportion of the company's total net income from its life insurance funds as locally paid premiums (*i.e.*, the premiums received from local policy-holders and also from foreign policy-holders whose proposals were made at or from the local establishment) bear to the total premiums of the company, less a corresponding proportion of the total management expenses of the company, likewise measured by the ratio of premiums.¹

491. In British India, the total net income of the Indian branch of any non-resident insurance company, whether life, marine, fire, accident, burglary or fidelity guarantee, or any other kind, in

¹ Income-Tax Act, 1918, Schedule D, Cases 1 and 3, No. 3 of Rules applicable to Case 3. See "Taxation of Foreign and National Enterprises", United Kingdom report, Vol. I, page 196.

the absence of more reliable data, may be deemed to be the proportion of the total net income, profits and gains of the company (computed according to the British India Act) corresponding to the proportion which the Indian premium income bears to the total premium income.¹ Certain non-resident life insurance companies make separate actuarial valuations for their British Indian business and, when these valuations are available, the assessment is based upon them, the assessment upon British Indian life insurance companies being based on such actuarial valuations.² Ordinarily, the profits of other types of insurance companies are computed on a commercial basis.

492. Whereas Canada does not tax the income of life insurance companies themselves, except for the amount credited to shareholders' account which is taxable, other insurance companies are taxed on the basis of their Canadian accounts.

493. South African law contains special provisions for assessing insurance companies, drawing distinctions (a) between mutual and non-mutual companies, and (b) between life insurance (including the granting of annuities) and other forms of insurance.³

494. As regards business other than "life" business, the taxable income of a mutual company is determined by first taking a proportion of the receipts or accruals arising from all investments in respect of the branches of insurance business other than life business in the ratio that the premiums received in the Union for those branches of insurance bear to the total premiums from all sources received by the company for those branches and, secondly, by deducting from the amount so ascertained an allowance for expenses of management; this allowance is fixed by taking a proportion of the total management expenses, other than commissions, in the ratio that the portion of the investment income from which it is to be deducted bears to the whole investment income of the company. For the purposes of this determination, the yield from all such investments, wheresoever located, is taken, so that the position may arise where a company is chargeable with Union tax upon investment income notwithstanding that it may have no investments within the Union.

495. *Non-mutual* companies are chargeable :

(a) In respect of "life" business, on a proportion of the dividends distributed to shareholders during the year of assessment out of profits earned by the life business carried on; this proportion is determined by the ratio which the sum represented by the premiums received in the Union for life assurance when added to the annuity payments made in the Union during that period bears to the sum represented by the premiums received from all sources when added to all payments made in respect of annuities. Where the business of the company extends to other branches of insurance, the proportion of the dividend distributed which is to be attributed to the life business is determined by taking the ratio of the profits earned by the life business during the period since the preceding distribution of a dividend to the profits earned from all branches of insurance during that period.

(b) In respect of other branches of insurance : on a taxable income determined by charging against the premiums and other amounts received in the Union from carrying on the business of insurance the actual losses and expenses incurred in the Union in respect of that business. In this determination, premiums paid for reinsurance are deductible from the premiums received, but the losses incurred are required to be reduced by the amount of any reinsurances received. Further, no provision may be made for unearned premiums.

¹ British India Income-Tax Manual, Rule 35.

² British Indian Income-Tax Manual, Rule 25.

³ First schedule to Article 40 of 1925, as amended by Acts 23 of 1927 and 30 of 1931.

496. Belgium taxes insurance companies on the basis of their accounts, which are required to show the income of each branch of insurance — *e.g.*, fire, life, etc. The special accounts should show gross premiums collected by the Belgian agency without deduction of premiums paid to re-assurers, the reserves corresponding to policies by the Belgian agency or contracted in Belgium by agents domiciled abroad, the interest on premiums and reserves, the amount of damages settled by the Belgian agency, the general expenses pertaining thereto, and, finally, the reinsurance operations concerning the policies concluded by the Belgian agency or contracted in Belgium by agents domiciled abroad. For the purpose of uniformity, the administration has prescribed a model profit-and-loss statement containing all the elements necessary for the assessment. Although not generally invoked, there is a legislative provision which authorises recourse, if necessary, to an estimative assessment with the following minima :

Life insurance.	20 francs	} per 1,000 of premiums received.
Maritime.	25 francs	
Other insurance.	60 francs	

497. The French law contains special provisions for taxing foreign insurance and reinsurance companies, allowing them the option of being taxed on the basis of an arbitrary estimate of their taxable profits or on the basis of the determination of their actual net income in accordance with the rules applicable to French companies. They may change their selection every year.

498. Under the arbitrary estimate system, the taxable profit is determined by applying a suitable coefficient to the amount of premiums either collected by foreign enterprises in France, Algeria and the French colonies and protectorates, or corresponding to risks in those territories. For every enterprise, this coefficient is equal to the ascertained proportion between taxable profits and premiums in the five most prosperous French companies insuring against risks of the same kind or engaged in the same business. These coefficients are fixed annually by the Minister of Finance and the Minister of Labour on the advice of a Board consisting of high officials and representatives of French and foreign insurance companies.

499. Foreign companies adopting the system of the arbitrary estimate of their taxable income must declare annually the amount of the premiums to be considered for the purpose of this estimate which they received during the previous year, showing separately the amount of the premiums in respect of each class of risk. After checking this declaration, the administration calculates the taxable income by multiplying the amount of the premiums to be considered in respect of each class of operation by the corresponding coefficient.

500. In the case of foreign companies which prefer to be taxed according to the same rules as French companies, the taxable income represents the sum total of :

- (1) The net business profit earned in the territories in which their French management operates (France, Algeria and French colonies or protectorates), and
- (2) The net income from movable or immovable capital employed as security for the operations carried out in these territories.

501. Certain of these operations are subject to French Government control, while others are not.¹ In respect of controlled operations, foreign companies are required in all cases to keep separate accounts at their French centre of management ; in respect of uncontrolled operations,

¹ Foreign enterprises operating in France are under the general control of the French State if they are engaged in life assurance, insurance against industrial accidents, or in the business of capitalisation and savings.

they are under that obligation if they prefer to be taxed on their actual profits. Foreign insurance companies which have asked to be taxed according to the rules applicable to French companies are taxed on the profit as shown by these separate accounts ; a declaration of this profit must be made annually, and is checked by the administration and amended, if necessary, after examination of the accounts. ¹

502. The Netherlands administration assesses foreign insurance companies on a coefficient basis, unless they elect to be taxed by fractional apportionment. ² Insurance companies are subject to the income-tax only on profits relating to premiums, or capital for constituting life annuities, received from persons living or established in the Netherlands, without regard to the place of payment of the premiums or capital or the circumstances surrounding the conclusion of the contract. The net taxable income is obtained by applying a coefficient of 10 per cent to the amount of the premiums and capital received from the insurees established or living in the Netherlands, during the accounting year preceding the year of taxation. Before applying this coefficient, the commissions or fees paid to representatives or third parties are deducted from the amount of the premiums. Under the fractional method, the taxable income is computed by applying to the total net income of the company the ratio existing between the amount of premiums and capital received from the insurees established, *i.e.*, having their fiscal domicile in the Netherlands, during the preceding accounting year, and the total amount of premiums and capital received during the same year.

¹ For the purposes of determining the taxable quota of the foreign company's distributed dividends and interest subject to the French tax on income from securities, the administration fixes the actual value of the French agencies, which, as a rule, is not shown in the balance-sheets of the foreign insurance companies, in the following manner :

In the first place, it ascertains the proportionate value of the French agencies to all the company's agencies. If no details are given in the balance-sheet, this figure is taken to be equivalent to the proportion between the French premiums — *i.e.*, the premiums payable in France under policies concluded in France — and the total premiums ; but as the premiums received only represent the company's business profit, whereas the profits it distributes are also derived from the yield of the investments representing its reserves, the proportion of the total profits represented by the business profits is ascertained.

This twofold operation may be expressed by the ratio :

$$\frac{\text{French premiums} \times \text{business profits}}{\text{Total premiums} \times \text{total profits.}}$$

Frequently, however, foreign insurance companies operating in France hold French securities and real property. This is the case with life assurance companies, which are bound under French law to secure their commitments in France by reserves partially constituted by French property.

The relative value of this property is determined by comparing the amount of the French investments with the total value of the company's assets (both as shown in the balance-sheets) ; it is then assumed that those investments contributed, in the proportion given by this comparison, to form the non-industrial profit, which is equal to the total profit less the business profit. The fraction thus obtained is added to the fraction representing the comparative value of the French agencies, and the reduction of these two fractions to one gives the taxable quota.

The mechanism of this operation will be made clearer by an example.

Suppose an insurance company has received French premiums representing 5 out of a total of 100, the business profit thereon being 2 out of a total profit of 4.

The comparative value of its French agencies is :

$$\frac{5 \times 2}{100 \times 4} = 0.025.$$

If the company owns French property representing 1 out of assets of 100, its non-business profit being 2 (4 - 2), the comparative value of its French property is :

$$\frac{1 \times 2}{100 \times 4} = 0.005.$$

Its taxable proportion will come out at $0.025 + 0.005 = 0.030$, or $3/100$.

² Netherlands Income-Tax Law, Article 29

503. The Netherlands East Indian law departs somewhat from the law of the mother country. In general, insurance companies are taxed on the basis of separate accounting, subject to verification, unless they elect to be taxed by fractional apportionment. Normally, taxable income is fixed for life insurance companies at 5 per cent and for others at 10 per cent for the amounts received in premiums or capital from insureds living or incorporated in Netherlands East India, or for risks in Netherlands East India, without deduction of commissions, rebates, reinsurance or other expenses. The fractional method is the same as that employed in the Netherlands. Sweden has similar provisions.¹

504. The Japanese Finance Ministry requires of foreign insurance companies that they keep separate accounts and submit to the Government, not only a report of the business done in the country, but also the inventory, balance-sheet, profit-and-loss statement and business report drawn up at the head office. Because of the nature of insurance business, few questions arise in determining the income of a company, but difficulties are encountered in allocating expenditure such as general overhead. Such expenses are apportioned in the ratio of premium receipts in Japan to total premium receipts.

505. The Mexican administration assesses insurance companies on the basis of their local accounts in accordance with provisions of the insurance law and also, in so far as deductible expenses are concerned, the income-tax law.²

506. The United States Revenue Act contains special provisions for taxing domestic and foreign insurance companies. In the case of a foreign life insurance company, an apportionment fraction is authorised, but, as there are very few foreign life insurance companies operating in the United States of America, there has been little occasion to test the practicability of the formula. The amount of the net income of a local branch of a foreign life insurance company for any taxable year from sources within the United States is the same proportion of its net income for the taxable year from sources within and without the United States which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.³

507. Fire and marine insurance companies, and insurance companies other than life or mutual, which constitute the most important category of foreign insurance companies operating in the United States, are subject to a special income-tax. For the purposes of this tax, gross income includes investment income (interest, dividends and rents) and underwriting income (premiums less expenses and losses) and gain from the sale or other disposition of property. It is evident that these sources of income are almost invariably situated in the United States, and therefore do not present questions of allocation. Only income from United States sources is stated in the return. Foreign insurance corporations, other than life, are allowed the same deductions as are ordinarily allowed to foreign corporations.⁴ In determining the allowable deductions, the principal source of difficulty is the allocation of a rateable part of the head-office expenses and taxes. In many cases, the United States branch is a relatively autonomous unit, subject only to a nominal supervision by the home office. Insurance contracts must be executed immediately and the branch must be in a position to pass upon them quickly and finally. There is, therefore, a question as to whether any deduction for overhead expenses should be allowed.⁵

¹ In Sweden the taxable income of foreign insurance companies is deemed to be a certain percentage of the gross annual amount of premiums received (without deduction of reinsurance premiums) on contracts concluded in the country, as follows : 5 per cent for maritime and transport ; 6 per cent for fire ; 15 per cent for life ; and 10 per cent for other classes of insurance.

² "Taxation of Foreign and National Enterprises", Vol. III, page 125, paragraph 94.

³ Revenue Act of 1932, Section 203(c).

⁴ Revenue Act of 1932, Section 204.

⁵ "Taxation of Foreign and National Enterprises", Vol. I, pages 256, 257.

508. Italy requires a separate accounting, showing investments in that country. The normal regime in Austria is that of separate accounting, but the treaties with Czechoslovakia and Hungary provide for the apportionment of total net profits in the ratio of annual net premiums.¹ The Hungarian authorities state that the normal regime is separate accounting or apportionment in the ratio of premiums. The German authorities state that they have no special method for handling foreign insurance companies, except that, if necessary, they may apportion the total net income in the ratio of receipts or premiums. Separate accounting is given as the basic method in Greece and Roumania. The following countries indicate that they have no special rules for taxing foreign insurance companies: Denmark, Danzig, Czechoslovakia (except for the treaty with Austria), Latvia, Luxemburg and Poland. Estonia has no problem because it does not permit foreign insurance companies to do business within its territory.

509. Of the two countries which use fractional apportionment, as the general method of assessing foreign companies, Spain has two regimes: ² (1) the law regime, and (2) the treaty regime. Where no treaty is applicable, the Spanish jury makes very detailed evaluations in fixing the proportion of premiums which is used in apportioning net income and attributes to the different branches of insurance different weights, these weights being deduced from the relation shown by the accounts between premiums and the profits of the different branches of insurance made by the enterprise in Spain. Furthermore, the jury takes into account the special conditions of competition or the existence of cartels or other forms of agreement between the different companies. Under the treaties which Spain has concluded, the maximum relative percentage applied to the total net profit is obtained by the relation between the amount of premiums received in Spain as compared with total premiums.

510. The Swiss cantons as a rule apportion the total net income of foreign insurance companies in the ratio of premiums. In one case, the apportionment was effected in the ratio of the premiums of the local establishment in the canton to the total receipts of the foreign company.³

511. Cuba does not impose the income-tax on foreign insurance companies, but subjects them instead to a tax on the total premiums received from insurees in Cuba. Likewise, in Massachusetts, insurance companies are not subject to an income-tax, but to a special levy on net premiums and reserves. In New York, a franchise-tax is imposed on gross premiums less specified deductions. In Wisconsin, a special tax is imposed on gross receipts.

TRANSPORT ENTERPRISES.

512. Relatively few problems of allocation have arisen in this field, because most of the railroads are owned or controlled directly or indirectly by the Government of the country in which they operate, and the profits of maritime navigation companies have almost universally been relieved of double taxation through bilateral arrangements for their exemption on a reciprocal basis. There are apparently few instances of motor-bus companies operating across frontiers. Likewise tax administrations are inclined to regard the question of allocating air-navigation profits as hypothetical, because, apart from the fact that for the most part such enterprises are supported by Government subventions, few of them have yet shown any profits.

513. The special practices and views of the various administrations are given below. The

¹ *Supra*, paragraph 258.

² "Taxation of Foreign and National Enterprises", Vol. I, page 156.

³ *Recueil des arrêts du Tribunal fédéral*, 1914, Vol. I, page 495.

countries which indicate that they have no special method of assessment include Czechoslovakia, Danzig, Denmark, Estonia, France,¹ Latvia and Poland.

Railroad Transport.

514. None of the tax administrations of continental Europe faces any serious problem of allocation in regard to land transport, because railroad companies as a rule are either owned by the Government or controlled through the terms of a concession to a private company. Consequently, there is a segregation of receipts and expenses incident to transportation within the frontiers of the State. The only important exception is that of the International Sleeping-Car and Restaurant-Car Company, the cars of which are attached to the trains of almost every European country. This company has a central accounting department which prepares a general statement of its entire receipts and expenditures, but divided into as many sections as there are countries in which it operates. It has reached informal arrangements with each State as to the method of apportionment and as to the assessable amount.

515. The Italian authorities indicate that they usually make the assessment by agreement with the company. The Spanish jury apportions income in the ratio of the relative amount of receipts obtained on the Spanish lines, sometimes allowing adjustments to take into account the difference in rates charged in Spain and those outside. Likewise, the receipts basis is used in apportioning income for the purposes of the tax in Roumania. The Belgian law provides for taxation on the basis of accounts subject to an arbitrary assessment, with a minimum taxable income, in the case of railroad companies, of 3,000 francs for each employee and worker, taking the average for the year in question; and for transport enterprises in general, a taxable minimum of 150 francs per 1,000 francs of receipts, provided this amount is not less than 10,000 francs for each employee and worker. Likewise, the German practice permits of recourse, if necessary, to fractional apportionment in the ratio of pay-roll, excluding *tantièmes*. Hungary, in respect of railroad enterprises which are not State-owned and other transport enterprises, follows the practice of separate accounts and recourse, if necessary, to fractional apportionment in the ratio of pay-roll. The Irish Free State administration indicates that the rule for apportionment in railroad cases is that of mileage, but, if there is only an office for making contracts for transport, the assessable profits would be computed on the basis of receipts from contracts made in the Irish Free State less local expenditure. For the purposes of the Swedish communal tax, railroad earnings are apportioned one-half in the ratio of value of traffic in passengers and goods; one-half in the ratio of pay-roll.

¹ France has special practices, however, for the purposes of the tax on income from securities. As a general rule, the taxable quota for railroad companies which hold a concession for a system or a portion of a system is obtained by comparing their French income with their total income. Only fares and freights collected in France are reckoned as French income, but if the company is a small one, and if its system consists of sections of track situated partly in France and partly abroad, the fares and freights in respect of the French section are reckoned as French income, wherever the money may actually be collected. In the case of other transport companies (travel agencies), the taxable quota is determined by taking the mean between the three following proportions: (1) the proportion between the French assets and the total assets; (2) the proportion between the expenses incurred by the company in respect of its staff in France and those incurred in respect of the whole of its staff; (3) the proportion between the commissions collected in France and the total commissions collected. Excepting companies subject to agreements for reciprocal exemption of their profits, in the case of foreign shipping companies whose vessels call at an authorized French port to pick up or land passengers or to load or unload goods, the taxable proportion is determined on the basis of the number and aggregate tonnage of the vessels and the number and tonnage of the vessels calling in France. By comparing these figures, it is possible to ascertain what portion of the material is allocated to French business. The result of this calculation is further checked by comparing the value of freights and passage-money collected in France with the total income of the enterprise. It is by this method that the taxable proportion for foreign air-navigation companies will be determined, but, so far, the administration has not been called upon to decide as to the application of this method to such enterprises. It will probably include either in the total income or in the total assets the amount of any subsidies such enterprises may have received from their country of origin. "Taxation of Foreign and National Enterprises", Vol. I, page 90.

516. The Netherlands income-tax law contains exceptional provisions for taxation on an arbitrary (*forfaitaire*) basis. If the railroad enterprise extends both within and beyond the frontiers, the taxable income is obtained by deducting from half of the gross receipts of the previous accounting year of the line situated in the Netherlands an amount corresponding to 4 per cent of the cost of installation (*frais de premier établissement*). If there is only a part of a line in the Netherlands, the gross receipts are calculated in the ratio of the length of the line in the Netherlands and the entire length of the railroad. If the line has only been used during a part of the previous accounting period, the amount deductible as interest on the cost of installation is reduced proportionately. If the tracks of a foreign company cross the frontier only to reach a station, the interested enterprise is exempt from the income-tax, subject to reciprocity. Tramway lines extending into the Netherlands are taxable on the same basis.

517. The treaties concluded by Austria with Czechoslovakia¹ and Hungary² provide that railroads are taxed in the country where the enterprise has its seat, provided its line does not extend into the neighbouring State more than fifteen kilometres in reaching the first junction station. If this limit is exceeded, the interested finance ministries will make a special agreement. If necessary, the apportionment may be effected in practice in the ratio of the number of ton-kilometres³ (*Tonnen-Kilometer*) attributable to each country.

518. As the railroads are owned by the Government in Switzerland, the Swiss authorities do not report any cases of international allocation. An inter-cantonal case, however, is interesting because of the theories of apportionment considered. The Federal Tribunal, on March 27th, 1914, held that a canton's share of the profits corresponded to the volume of traffic in the canton as compared with the total volume of traffic. The factor "length of line" was rejected as a basis for the fractional apportionment, because the different parts of the line were of unequal value and the traffic was not of equal volume for the whole line. Moreover, account had to be taken of the fact that the seat and management of the company were in another canton.⁴

519. With regard to the Western Hemisphere, there are few instances of transport lines crossing the frontiers between the United States and Canada, and also of American enterprises extending their operations into Mexico. The United States Revenue Act of 1932, Section 119(e), and the Regulations pertaining thereto (Article 683) contain specific provisions pertaining to the income from transportation or other services rendered partly within and partly without the United States. The allocation formula prescribed in Article 683 is seldom, if ever, invoked in the case of railroad or motor-bus companies, but is frequently employed in the case of shipping enterprises of countries which have not entered into arrangements for the reciprocal exemption of such profits authorised by Sections 212(b) and 231(b) of the Revenue Act and similar provisions in prior Acts. In any event, the taxpayer may apply for permission to base his return upon regularly kept books of account which allocate receipts and expenditures in a manner reflecting more clearly than the process mentioned the income derived from sources within the United States.

520. The few instances in which companies operate across frontiers of the United States do not present great problems, because every railroad operating in the United States must submit an annual statement to the Inter-State Commerce Commission, which prescribes the manner in which the accounts are to be kept, determines the rates and requires a statement of the portion of through

¹ Article 1, "Collection", C.345.M.102.1928.II, page 120.

² Article 1, *ibid.*, Vol. III, page 27.

³ "Taxation of Foreign and National Enterprises", Vol. II, page 34.

⁴ *Ibid.*, Vol. II, page 455.

tariff rates which is allocable to the United States. This Commission has indirect control over the division of international through rates in that, if revenues are shifted to a contiguous country in a proportion in excess of what is deemed to be required for operations and to provide a fair return, the Commission can initiate proceedings to reduce the rates charged for transportation. Rates schedules for the divisions of a railroad are filed with the Commission for reference, and the division of through-rates made for the Inter-State Commerce Commission is accepted by the Bureau of Internal Revenue. The apportionment of through rates for transportation originating in one country and destined to another is made on an equitable basis, the mileage factor being given due consideration. As an example of the method of allocation employed in practice, the gross revenue of a Canadian company which has about 192 miles of line in the State of Maine was allocated to the United States in the ratio of mileage in the United States to total mileage of the entire system. From this amount, there was allowed as a deduction a proportionate part of the total interest accrued on obligations of the Canadian company. In the case of a railroad connecting Canada and the United States through a tunnel, a few small items are entirely allocated to the country to which they can be definitely assigned, but substantially all the income is apportioned in the rate of 50 per cent to each country. The same method is followed in the case of a bridge connecting the countries at Niagara Falls.

521. In the case of two American companies which extend their railroad services into Mexico, for the purposes of the tax in the latter country, separate accounts are kept showing the amounts received for transportation and accommodation in Mexico and the deductible expenses pertaining to the operations in Mexico.

522. The British Indian authorities state that they have no problems of allocation with regard to the protected and feudatory Indian States, as well as the parts of India belonging to France or Portugal, because, in most cases, the profits derived from freights or fares paid for transportation into those territories are received in British India and are taxable there.

523. In the States of the American Union which were considered in this survey, allocation for income-tax purposes is avoided because railroads are taxed on other bases. Massachusetts and New York subject railroads to franchise-taxes and Wisconsin to a tax based on an evaluation of their physical property.

Autobus Transport.

524. The various administrations report that they have not yet had cases of allocation presented by autobus companies operating internationally. The opinion of officials in the United States Bureau of Internal Revenue who had handled such cases was that the revenue and expenses of such operations might be apportioned on a mileage basis. This same measure is indicated by the Wisconsin income-tax authorities.

Maritime Navigation Companies.

525. The problem of allocation has been almost completely eliminated in the case of sea transport companies because of the almost universal adoption of the principle that such profits should be taxed only by the country in which the company is domiciled or under the laws of which the ships are documented.¹ The United States inserted in its Revenue Act of 1921 an offer of reciprocal exemption and this measure has been repeated in subsequent Acts. The Revenue Act

¹ Over a hundred years ago, the Netherlands exempted foreign shipping enterprises from the *patente*, and to-day that country exempts them under the Income-Tax Law, Article 3.

of 1932, in Sections 212(b) and 231(b), provides that the income of a non-resident alien individual or a foreign corporation "which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States, shall not be included in gross income and shall be exempt from taxation" under the Act. Practically all the great maritime countries have met the requirements of the United States Revenue Act for exemption of their own ships,¹ and have entered into arrangements between themselves.²

526. Perhaps the most recent provision is that contained in the Netherlands East Indian tax law exempting, as from January 1st, 1933, non-resident shipping enterprises in respect of profits derived from freight and passenger services between foreign countries and Netherlands East India, but not from inter-island transportation.³

527. Governments which have not entered into such reciprocal arrangements include Australia, British India, Mexico and New Zealand. Cuba avoids the difficulty of allocation by taxing foreign shipping on the gross amount paid for freight and passage from Cuba to foreign ports. Massachusetts subjects shipping companies to a special excise-tax and New York imposes a franchise-tax.

528. The reason for the spread of the principle of reciprocal exemption is primarily due to the great difficulties in determining that part of the profits of an enterprise carrying passengers or freight from country to country which is attributable to one of the countries involved. The difficulties in measuring this income are evinced by the formula used by the various administrations in taxing companies not subject to the regime of reciprocal exemption. The simplest is that employed in a few cases by the United Kingdom authorities, which consists in assessing as local profits that part of the total profits of the company as the United Kingdom receipts bear to the total receipts. Likewise the Japanese administration, in the absence of a reciprocal arrangement, may resort to apportioning general profits and expenses in the ratio of freight and fare receipts in Japan to total freight and fare receipts.

529. In applying its general rule of taxing on the basis of receipts less expenditure, the Mexican administration, in taxing a foreign shipping company, deducts from the local receipts for freight and passages the expenses of the local branch and a certain portion of the expenses incurred in the operation of ships outside Mexican waters. This apportionment presents great difficulties and many of these cases are appealed to the board of revision.

530. The British Indian authorities have evolved detailed provisions for assessing the profits of ocean transport companies, which, broadly speaking, apportion the world profits, computed in accordance with the Indian Income-Tax Act, in the ratio of Indian receipts to total receipts.⁴

¹ The following is an incomplete list of foreign countries which either impose no income-tax or, in imposing such tax, exempt from taxation so much of the income of a citizen of the United States non-resident in such foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States: Belgium, Brazil, the United Kingdom, Bulgaria, Canada, Denmark, Egypt, France, Greece, Iceland, Italy, Japan, the Netherlands, Norway, Paraguay, Persia, Roumania, St. Lucia, Siam, Spain, Straits Settlements, Sweden and Venezuela.

² For agreements for reciprocal exemption of shipping profits and provisions in internal legislation authorising such an exemption, see "Collection", C.345.M.102.1928.II, Supplement No. 1 (1929), Vol. III (1930), Vol. IV (1931), etc..

³ Income-Tax and Company-Tax Ordinances, 1932; "Taxation of Foreign and National Enterprises", Vol. III, page 158, paragraph 120.

⁴ "Taxation of Foreign and National Enterprises", Vol. III, pages 44 and 45, paragraph 127.

531. South African law¹ has special provisions for assessing foreign enterprises carrying on the shipping business in the Union. The primary method of assessment is upon a taxable income determined by taking 10 per cent of all amounts paid in respect of passengers, live-stock, mails and goods shipped in the Union. Provision is, however, made for assessment on the ordinary basis where accounts satisfactory to the Commissioner can be rendered.

532. For some years, the 10 per cent basis was applied throughout, as no shipping companies were able to comply with the requirements of the administration as to accounts. From the nature of the business carried on by them, any accounts purporting to deal with the transactions of a shipping company in the Union involved approximations and estimations under most of the heads of expenditure. As the result, however, of later negotiations, arrangements have been made with the majority of the foreign enterprises carrying on business in the Union, whereby a certificate from the taxing authority exercising jurisdiction over the profits of the enterprise as a whole indicating the rate of profit earned by it upon receipts is accepted as indicating, for the purposes of Union taxation, the rate of profit applicable to the receipts derived from transactions in the Union. Subject to such adjustments as may be rendered necessary by the provisions of the taxing measure under which the rate of profit has been determined, the certificate, together with the statements of the Union receipts, is accepted as an account satisfactorily disclosing the taxable income derived from the business conducted in the Union.

533. The assessment of tramp steamers, save where such vessels belong to a regular line, is still made on the percentage basis, and the Act gives special powers to secure payment of the assessments where the tramp owner has no recognised agent in the Union other than the master of the ship.

534. The United States Bureau of Internal Revenue, when taxing the ships of countries which have not entered into the regime of reciprocal exemption, observes Article 683² of the Regulations pertaining to the Income-Tax Act, which contains a complicated apportionment fraction, taking into account the ratio between the sum of the costs or expenses of such transportation business carried on within the United States and a reasonable return on the property used in such transportation business within the United States, and the sum of the total costs or expenses of such transportation business and a reasonable return on the total property used in such business. Nevertheless, the taxpayer may apply for permission to base his return upon his regularly kept books of account showing a detailed allocation of receipts and expenditure which reflects the income more clearly than the preceding method. There is little occasion, however, to use the preceding formula, as practically all large shipping companies are under the regime of reciprocal exemption.

Lake and Fluvial Navigation.

535. The general rule observed in the case of sea transport is applied as well by a number of countries in lake or river transport. Wisconsin subjects to income-tax only the earnings of lake vessels registered in Wisconsin ports. The Netherlands exempts the earnings of foreign vessels operating in the rivers or other waterways through its territory provided the transport is not purely internal. In the treaties³ concluded by Austria, the exclusive right to tax the earnings of ships navigating the Danube is reserved to the country in which the seat (*Sitz*) of the enterprise is situated.

¹ Section 16, Income-Tax Act, No. 40, of 1925.

² "Taxation of Foreign and National Enterprises", Vol. I, pages 259 to 261.

³ Austria and Czechoslovakia, Article 2, "Collection", page 120; Austria and Hungary, Article 14 (1), *ibid.*, page 48.

In the case of foreign enterprises not under the treaty regime which do not keep adequate separate accounts of their Austrian profits, the income is apportioned in the rate of ton-kilometres.

Air Navigation.

536. No administration reports as yet that it has had occasion to tax income from air navigation, as such companies have hitherto been unprofitable and have had to receive, in many instances, subventions from their home Governments. Nevertheless, liability to tax such income exists in most countries with an income-tax. The Netherlands East Indian administration has exempted foreign air-navigation companies under the provisions described above in connection with foreign shipping companies.

537. The general tendency is to assimilate air-navigation enterprises to maritime navigation enterprises, and to subject them to the same methods of assessment. Thus, the United Kingdom administration has adopted, as a provisional rule, the apportionment of the total net income of such a company in the ratio of receipts. In British India, such income would be taxable there if it arose, accrued or were received there. Cuba subjects such companies to a tax of 3 per cent on the gross receipts for freight and passenger fares from Cuba to foreign countries. The Mexican regime for air-navigation companies is the same as that for foreign shipping companies. The United States revenue officials have as yet had practically no cases involving foreign air-transport companies, but the formula described above¹ in connection with shipping companies would be applicable unless the Commissioner permits the taxpayer to base his return upon his regularly kept books of account reflecting the income more clearly.

POWER, LIGHT AND GAS ENTERPRISES.

538. Practically all administrations report that they have not developed any special methods of allocation for enterprises supplying power, light and gas, for the simple reason that no cases have arisen. If such an enterprise should operate across frontiers, the general indication is that the establishments in each country would be subject to taxation on the basis of their accounts, with recourse, if necessary, to assessments on an empirical or fractional basis. Under the United States Revenue Act, such an enterprise would be taxable under Section 119(e) regarding income from sources partly within and partly without the United States. Under Belgian law, an establishment would be taxable on its accounts, subject to recourse to an arbitrary assessment on the basis of 150 francs per 1,000 francs of receipts, provided this amount is not less than 10,000 francs per worker or employee.

539. The Spanish profits jury has followed no special rules except that the income of companies supplying both electric light and gas are apportioned in the ratio of assets, taking into account the credits granted and obtained by the enterprise. The preliminary estimate thus made is then modified on the basis (1) of the rate charged, and (2) of the price of coal in Spain. In certain cases, a further adjustment is made to take into account appreciable differences in the relative frequency of services. The resulting estimate is compared with that derived from the book-keeping and, if the difference between the two is not unreasonable, the profits shown by the books are taken as a basis. When the figures diverge greatly, as is frequently the case, mainly owing to the prices charged for the coal and other materials supplied to the Spanish establishments, the result of the

¹ *Supra*, paragraph 534.

previously described computation is employed for fixing the relative percentage adopted by the jury.

540. The Swiss Federal Tribunal, in a case involving an electric power station on the Swiss frontier with its seat of management in Switzerland and installations in a neighbouring country, allocated the income on the basis of the factors of production — *i.e.*, capital and pay-roll — rather than on the basis of receipts for current consumed, in order to take into account the activity which produced electric current.¹

541. The following countries indicate that they have no cases of this nature, or that they have no special rules for dealing with them: the United Kingdom, the Irish Free State, British India, Canada, South Africa, Luxemburg, France,² Italy, the Netherlands, Netherlands East India, Denmark, Sweden,³ Germany (except as a last resort, fractional apportionment in the ratio of pay-roll excluding *tantièmes*), Danzig, Austria, Czechoslovakia, Hungary (except for a preference for separate accounting with recourse, in the last analysis, to fractional apportionment in the ratio of pay-roll), Latvia, Estonia, Poland, Greece, Roumania, Japan, Cuba and Mexico. In Mexico, there is one company which purchases power from another company situated within the United States frontier, and the Mexican company is taxed on the basis of its receipts, less the cost of power and other expenditures. Under Wisconsin law, a foreign company cannot own the assets of a public utility enterprise and, consequently, there is no question of allocation. Although the stock of a public utility company may be owned by a foreign corporation, the Public Service Commission would not allow unjust expenses to be incurred by the Wisconsin company. Massachusetts and New York subject such enterprises to franchise-taxes which are not based on income.

TELEGRAPH AND TELEPHONE ENTERPRISES.

542. Few cases of allocation methods are reported in respect of telegraph, telephone, cable and radio enterprises, the principal reasons being that telegraph and telephone services are frequently Government-owned or belong to companies which have received concessions from the Government, and because so many of the world cables belong to very few companies. Where taxable, such enterprises are subject to the normal regime of assessment on the basis of accounts with recourse, if necessary, to empirical or fractional methods.

543. The United Kingdom authorities tell of one case in which the local profits were computed at the same proportion of the total profits as the local receipts bore to the total receipts. In another case, the United Kingdom profits were based on United Kingdom receipts, less expenses relating exclusively to the United Kingdom establishment and a proportion of the overhead expenses (*i.e.*, those not relating exclusively to a particular country), fixed on a "user" basis — *i.e.*, in proportion to the number of words transmitted out of the United Kingdom. The principle in the Irish Free State is to assess the local profits as that part of the total profits from the same class of business as the local receipts bear to the total receipts of the same class of business.

¹ Judgment rendered December 22nd, 1926. See "Taxation of Foreign and National Enterprises", Vol. II, page 456.

² For the purposes of the French tax on income from securities, however, the taxable quota is fixed by comparing the value of the works or other property in France and the total value of the French and foreign establishments. "Taxation of Foreign and National Enterprises", Vol. I, page 90.

³ For the purposes of Swedish communal tax the income of such enterprises is apportioned in the ratio of 10 per cent to the commune of the principal seat, 25 per cent to communes where are situated productive installations, and 65 per cent to communes where consumption takes place.

544. The South African Government assesses companies transmitting messages by cable or wireless to places outside the Union on the basis of a taxable income equal to 5 per cent of the gross earnings in respect of any messages transmitted from any office in the Union.¹

545. The Netherlands East Indian administration also apportions the total net profits of a cable company in the ratio of receipts. In Italy, such means of communication are a State monopoly or are conceded to private companies supervised by the Government. An Italian cable company, however, which, in part, uses cables belonging to other companies, presents problems of allocation, but their solution is facilitated by the terms of its concession and those of its agreements with the foreign companies.

546. In Japan, the situation is much the same. In the one or two cases where a foreign company is assessable, the tax is levied on the basis of the separate accounts showing local receipts and the expenses incurred exclusively in respect of business in Japan, together with charges paid to other companies for further transmission. General overhead is allocated by the most adequate method, for example, by the ratio of assets or business receipts. The Cuban administration has experienced such difficulties in assessing enterprises of this type that it has secured the passage of a law² which substitutes a tax on gross receipts of local branches, subsidiaries or agents of foreign companies engaged in transmitting messages by radio, cable or radiotelephone, when their accounts are unsatisfactory. Apart from this tax, a stamp-tax is payable on each message.

547. As most communication companies operating in the United States of America are American-owned, the federal administration has not been faced with any problems of allocation, but, if necessary, the officials consider that the total net profits might be apportioned in the ratio of receipts or expenses. These types of enterprises are subject in Wisconsin to the same rules as power, light and gas enterprises. Massachusetts and New York subject them to franchise-taxes.

548. The administrations of the other countries covered in the survey state that either such enterprises are Government-owned, exempted by terms of a concession, or that they have not developed any special rules for assessing them. These countries include : British India, Canada, Belgium, Luxemburg, France,³ the Netherlands, Switzerland, Denmark, Sweden, Germany, Danzig, Austria, Czechoslovakia, Hungary, Estonia, Latvia, Greece and Roumania.

MINING ENTERPRISES.

549. Few administrations report difficulties in connection with mining enterprises, for the simple reason that minerals or oil extracted are usually prepared at the mine for sale on the world markets, and consequently the world market price delimits the profit allocable to their territory. Such is the case notably in countries primarily productive of minerals or oil, including Canada, Netherlands East India, Mexico, Roumania, Spain and the United States of America.

550. Nevertheless, if a foreign enterprise mines a product in Canada and ships it abroad for further processing or sale, the profit is apportioned according to a method determined in the given

¹ Section 17, Act 40 of 1925.

² Law of September 23rd, 1932, Article 1 (5).

³ In France, the only occasion for special methods is in connection with fixing the taxable quota for the tax on income from securities payable by foreign companies with cables to France and having an agency there. The quota is fixed by the ratio between the proceeds of the French traffic and the total proceeds of the telegrams despatched by all the stations of the company. See "Taxation of Foreign and National Enterprises", Vol. I, page 90.

case by the revenue authorities.¹ If the Canadian mining establishment sells the product, the profit is taxable in the same manner as that of an industrial company and some allowance would be made for the general overhead of the head office situated abroad. Canada gives no allowance for depletion.

551. South Africa requires mining enterprises to render accounts for each mining unit, as the redemption allowances depend upon the life of the mine. The taxable income is therefore readily determined. The whole of the sale price of the product must be brought into account as derived from a source within the Union, irrespective of the place where the product is disposed of.

552. The Netherlands East Indian authorities state that they encounter no difficulties, because the operations do not, as a rule, extend abroad. Where a world concern operates local oil-wells, the basis for calculating the production profit has been the so-called "gulf price" of oil. All the oil sold in Netherlands East India is produced there.

553. Foreign mining and extractive companies with establishments in the United States of America are subject to the same allocation provisions as those described above² in connection with enterprises producing without and selling within the United States, or *vice versa*. In other words, where minerals are produced without and sold within or produced within and sold without the United States, the profits derived are treated as income partly from sources within and partly from sources without the United States. The part of the income allocable to the country of production is that determined by the price at which the product would be sold to independent purchasers. If no such price can be determined, the part of the net income which is allocable to the United States is computed by apportionment on the basis of property and gross sales. The taxpayer may apply for permission to base his return upon his regularly kept books of account, when they show a detailed allocation of receipts and expenses which reflect more clearly than the preceding method the income derived from sources within the United States.³ No difficult problem has arisen in applying the rule of the independent production price in the case of the very few mining enterprises with branches in the United States. The United States Revenue Act grants an allowance for depletion.⁴

554. It may be pointed out at this juncture that the American revenue authorities have had to face more problems in connection with American enterprises operating mines in foreign countries and selling the products in the United States. This is especially true in cases where the real centre of management of the undertaking is in New York and all the producing activities of the company are carried on at the mine in a foreign country. The question arises as to how much of the general overhead, including bond interest and salaries of officials, should be allocated to the foreign country. Another difficulty is that, whereas the Revenue Act allows American enterprises to claim a certain depletion allowance even when the depletion takes place at a mine owned by the American enterprise in a foreign country, very few foreign countries grant allowance for depletion, and this results in the computation of a much larger net income from the mine under the laws of the foreign country than that computed under the provisions of the United States Revenue Act. This discrepancy becomes of special importance when computing the credit allowed American enterprises in respect of income-tax paid abroad on foreign income.⁵

555. Certain oil companies, extracting oil in one country, refining it in a second and selling it in the United States, have been able to segregate the profits of each stage of the business, because

¹ Article 26 of the Canadian Income War Tax Act, Chapter 97, R. S. C. 1927: *supra*, paragraph 438.

² *Supra*, paragraphs 63 and 64.

³ Revenue Act of 1932, Section 119 (e); Regulations 77, Article 682.

⁴ Section 114.

⁵ Revenue Act of 1932, Section 131.

of there being a market price prevailing for the production at each stage. In the case of mining companies, however, the same enterprise usually handles all the stages from mining the ore and smelting it to the sale of the finished products, and it has been found difficult to determine fair market prices for the product at each stage. It has been proposed as a general rule, that if the product has an established market value in the country in which produced, such value should be considered to represent gross income in such country. The difference between that value and the price at which the finished product is sold in another country should be considered as the gross income to be allocated to the latter country. In general, transport, insurance, selling cost and overhead would be the main deductions allowable against this gross income in arriving at the net taxable income in the country of sale.

556. The Bureau of Internal Revenue has recognised that copper, as well as gold and silver, is a metal which has an international market and can always be sold at any place and in any stage of preparation for the current market price at New York or London, minus the cost of laying down the metal in refined form at New York or London, respectively. This being the case, the value of such metals as copper, silver and gold at the place of production reflects the gross income attributable to the country in which the mine is located. If the question were one of determining what part of the profit derived from the sale without the United States of copper produced within the United States was attributable to sources within the United States, the readily determinable market value of such copper in the United States would be used as a basis for computing the profits attributable to the United States. This value would reflect the production price, "otherwise established — unaffected by considerations of tax liability", within the meaning of Case 1 (A) of Article 682 of Regulations 77. Therefore, in determining what part of the profit derived from the sale in the United States by an American company of electrolytic copper produced at its plant in a foreign country is from sources within the foreign country, the value of the copper in the foreign country should be taken to reflect the gross income from sources within the foreign country and should be treated as an independent production price "otherwise established" to the satisfaction of the Commissioner. In such case, this production price or value is the New York market price less transport and other delivery costs, carrying charges, insurance and selling commission of the agency selling the copper.¹

557. Under Mexican law, a segregation of profits on the basis of separate accounts is necessary, because of the fact that a local company must be organised to carry on a mining undertaking. The assessable profit is ordinarily the difference between the price received for the minerals or oil on the world market less the cost of extraction and other deductible expenses. As the Mexican Constitution declares the subsoil to be the property of the State, the local company receives only a concession to extract the oil or mineral, and is not allowed any deduction for depletion.

558. Spain subjects foreign companies mining in Spain to taxation under its whole regime of fractional apportionment. The Spanish practice envisages three cases: (1) purely mining companies; (2) enterprises exploiting mines and transforming the ore in Spain or elsewhere; and (3) enterprises in which mining plays only a secondary or complementary role in the entire business.

559. With regard to purely mining companies, they usually operate exclusively in Spain, except for the centre of management abroad. The problem of allocation is therefore reduced to the determination of the importance of the direction of the enterprise. In most of these cases, the market for the minerals has been organised for a long time and the management has practically no important problems to solve. In general, the jury assigns about 10 per cent of the profits to the

¹ G.C.M. 7545 IX-15-4598, C.B. IX-1, page 215.

centre of management and 90 per cent to Spain. This figure is the result of experience gained in a number of cases.

560. Where an enterprise both mines and transforms minerals in Spain and abroad, the jury may attempt to ascertain the relative importance of the two departments. If it is impracticable to make this separation, one employs as a basis the amount of the capital engaged in each department. Very frequently, one considers the result of this method as only a first estimate, subject to subsequent modifications if there are special circumstances such as differences in the risk incurred by the capital.

561. Income from securities held by these companies is always assigned to the centre of management abroad. Another general rule in the Spanish practice is that minerals held in warehouses which are almost always situated in Spain are excluded from the computation. The reason is that the enterprise can very well store these minerals outside of Spain if the difference in the amount of the tax would make it worth while. The Spanish practice is guided by the principle that, unless the law imposes another solution, the tax must not interfere with the most economic conduct of the enterprise.

562. It is also important to note that the part of the assets represented by the mineral deposits is not taken from the accounts of the company, but is the object of a special evaluation by the mining experts of the Government. The experts of mining companies have frequently suggested to the jury that it employ the method based on the difference between the value of the deposits and the cost of production, but this method has been rejected because of the very large differences resulting from the variations in quality. The control of the quality by the administration is practically impossible, because of the variation in quality in the same deposits.

563. Where mining plays only a secondary part in the entire business of an enterprise, the jury makes the separation of profits by the ordinary methods, and, if the profits of mining in Spain are absorbed by the losses of the other kinds of business in Spain, the enterprise is not taxable on such profits.

564. The Italian authorities, in assessing the mining organisations operating especially in Sardinia, verify their balance-sheets by reference to information supplied by the Bureau of Mines, concerning the quantity extracted annually, the products prepared for exportation and the prices. In Switzerland, only one case is reported, that of a British company owning asphalt mines. In Neuchâtel, and allocation difficulties were obviated by levying a flat rate per ton of asphalt extracted. In Greece, some of the few foreign companies operating mines have elected to be taxed as Greek companies and are therefore assessable on the basis of distributed income. In Japan and Roumania, the extractive industries belong to national companies.

565. The following countries report that no cases of allocation have been presented by such enterprises, or that they have developed no special rules for assessing them: the United Kingdom, the Irish Free State, British India, France,¹ Luxemburg, the Netherlands, Denmark, Sweden, Germany

¹ For the purposes of the French tax on income from securities, however, in the case of companies which hold concessions for mineral deposits in France, the taxable quota is determined by comparing the tonnage extracted from the concessions in France with the total tonnage of the ores extracted by the company. If the deposit for which a concession is granted in France is not worked, a comparison is made between the value of that deposit and the total assets of the company; the value of the deposit is obtained by estimating the quantity of ore in the deposit in tons and multiplying by the cost or estimated value per ton. "Taxation of Foreign and National Enterprises", Vol. I, page 91.

(except possibly fractional apportionment in the ratio of pay-roll excluding *tantièmes*), Danzig, Austria, Czechoslovakia, Hungary (except that separate accounting would be preferred, with recourse in the last resort to apportionment in the ratio of pay-roll), Latvia, Poland and Estonia. Wisconsin would tax such an enterprise as an industrial corporation, and Massachusetts would subject it to a franchise tax. New York has no special provisions.

OTHER KINDS OF ENTERPRISES.

566. The various administrations do not report that they have had any occasion to evolve special methods of allocation for any other kinds of enterprises. Cuba has obviated difficulties in the case of moving-picture companies by imposing a tax on the gross receipts, in substitution for the income tax, of foreign companies which dedicate themselves to the sale, leasing, exhibition or exploitation in any manner of cinematographic films, and also of such foreign companies which contract with Cuban companies stipulating that they shall receive a certain per cent of the receipts in Cuba. ¹

¹ Law of September 23rd, 1932, Article 1(5).

CHAPTER X.

NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

GENERAL METHODS OF ALLOCATION.

567. When occasion arises to allocate the profits of a national enterprise¹ as between local and foreign establishments, fiscal administrations apply essentially the same methods that have been described above regarding foreign enterprises with local branches or subsidiaries. The fiscal authorities of the home State have an advantage, however, over the authorities of the State in which the branch is situated, in that they may readily verify the balance-sheet and profit-and-loss statement of the enterprise as a whole, and the burden is more or less upon the taxpayer to show that a certain portion of the total profits should be allocated to a foreign branch. Companies frequently incorporate their branch establishments in a foreign country, and this necessitates a close examination of the prices at which goods are invoiced or charges of any kind are credited to the foreign branch in order to circumvent the shifting of income from the parent company to the subsidiary abroad. In general, profits transferred to the foreign subsidiary may be reached by resorting to the same measures as have been previously described in connection with the taxation of a local subsidiary of a foreign enterprise.

568. The cases in which it is necessary to allocate or apportion income as between a national enterprise and its foreign branches or subsidiaries are constantly increasing in number, partly because of the conclusion of double-taxation treaties limiting the fiscal jurisdiction of a State to profits attributable to the local permanent establishment of an enterprise operating in both contracting States, and partly due to the increasing efforts of tax officials to make sure that the full profit attributable to the home establishments is brought into assessment. For example, the United States Revenue Act of 1932, Section 131(e), imposes new limitations upon the credit allowed against the United States tax in respect of taxes paid abroad on foreign income which necessitate an allocation or apportionment of income as between the United States and each foreign country in which the taxpayer has derived income subject to the tax for which credit is claimed. The allocation of income as between the foreign country and the United States is a prerequisite, because the credit against the United States tax is limited, in respect of the tax paid or accrued to any foreign country, by the ratio of the taxpayer's net income from sources within such foreign country to his entire net income for the same taxable year. Furthermore, the total amount of the credit for foreign taxes shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's net income from sources without the United States bears to his entire net income for the same taxable year.² In other words, the United States imposes its tax on the total income of

¹ For definition, see paragraph 16, footnote.

² Section 131 (b).

a citizen or domestic corporation, and the taxpayer must satisfy the Commission of Internal Revenue with regard to the amount which is deductible from this tax in respect of the tax or taxes paid abroad.

569. Countries which have a special interest in the allocation of profits of national enterprises are those which exclude, from the assessment of their profits tax, the profits attributable to a permanent establishment situated in another country, notably France, Italy, Estonia, Denmark, Latvia and South Africa. Italy conditions this exemption¹ upon the foreign branch being operated as an autonomous unit and having a complete separate accounting. As this treatment is an exception to the general rule that income derived in Italy, as well as from activities abroad, is to be regarded as realised at the seat in Italy which directs its activities and issues instructions, the authorities, in granting this exemption, verify the income shown in the branch accounts by comparison with those of the seat and rectify any transfer shifting the profits or losses from one to the other. Reference is sometimes made to the assessment levied by the foreign tax administration and also to assessments levied by the Italian administration on the local branches of foreign enterprises engaged in the same type of industry or commerce.

570. The French exemption for profits attributable to an establishment outside France is in conformity with the principle of territoriality which underlies the tax on industrial and commercial profits. Thus, if the establishment in France extends its activities into foreign countries without having there any permanent establishment, it is assessable upon the whole of its profits, but once operations are effected through another establishment outside France, the profits allocable to the latter are excluded from assessment in France. The assessment to the French tax is therefore subject to the following limitations :

(1) If a foreign branch engages in purchasing and selling goods, the entire profit derived from such transactions is allocated to the foreign establishment.

(2) If the French establishment purchases goods wholesale and ships them to the foreign establishment for sale, the profit attributable to sale is excluded, and the French assessment is limited, as a rule, to that part of the profit which the French establishment would earn, on the wholesale shipment of the products to the foreign branch, if it were selling to third parties. If this part of the profit attributable to the French establishment cannot be exactly determined from the accounts, it should be computed in accordance with the most appropriate empirical method previously described.²

(3) If the foreign establishment purchases goods which are sold by the establishment in France, the French assessment is limited to the profits which would be made if, instead of obtaining the goods from its own buying office abroad, it employed a French import commission agent. In principle, this profit should be determined on the basis of the general accounts kept in France, as adjusted if necessary. The expenses on account of the buying office should be deducted from the general expenses, but the purchase price of the goods despatched by that office should be increased by the amount of the commissions which would normally have been paid to the middlemen, mentioned above, had their services been employed. If necessary, the profit of the French establishment may be estimated by a comparison with the turnover of similar enterprises.

(4) If the French establishment sells goods which have been manufactured at a factory abroad, the French assessment is limited to the sales profit, as distinct from a manufacturing profit, attributable to the factory abroad. The sales profit corresponds to that which the

¹ Law of August 12th, 1927.

² *Supra*, paragraphs 156 *et seq.* and 167.

French enterprise would earn if, instead of obtaining its supplies from its own factory, it obtained them from independent foreign factories. For the purposes of assessment, therefore, the profit in question must be separated from the general profits of the French enterprise. If the accounts of the enterprise do not reveal the exact amount of these profits — for example, because of the goods being transferred from the factory abroad to the French establishment at an artificial price approximating the sale price — the sales profits may be determined by a comparison with similar enterprises, taking into account the receipts from sales effected by the French establishment, or the number, quantity or volume of the goods sold.

571. The Estonian authorities state that the national enterprise is not taxable on the profits attributable to branches abroad, although this income may have been credited to the principal establishment in Estonia. The Danish administration exempts that part of the net profit of a Danish enterprise which is attributable to a foreign establishment, in the ratio of foreign gross profits to total gross profits. South Africa applies strictly the principle of taxing only income derived from sources within the Union, and therefore excludes income from business operations carried on outside the Union.

572. The Austrian, Czechoslovak and Hungarian tax laws exempt the profits of a national enterprise attributable to an establishment in another country, provided the latter country taxes such profits and accords a reciprocal exemption in respect of profits allocable to foreign branches of its national enterprises. The Austrian and Czechoslovak laws, however, reserve to the home country a minimum quota, in accordance with the theory that a national enterprise, even when its operations are mainly foreign, nevertheless enjoys the same protection and advantages as an enterprise operating exclusively in the home country. In the case of enterprises belonging to individuals and partnerships subject to the general profits tax, this quota is at least one-fourth of the total net profit of the enterprise, and in the case of companies subject to the company tax, it is at least one-tenth of the total net profit. This minimum quota of one-tenth has been incorporated in the Austro-Hungarian treaty on allocation. It is to be noted that this fraction is applied to the total net income, and not to the joint income of a local establishment and an establishment in a foreign State. The joint income is subject to the taxable minima in the Austrian law which have been incorporated in the form of apportionment fractions in the treaties with Czechoslovakia and Hungary — namely, income derived from purchasing at an establishment in one country and selling at an establishment in the other is to be equally divided, and that derived from manufacture in one country and sale in the other is to be apportioned in the ratio of two-thirds to manufacture and one-third to sale.

573. Luxemburg only allows the deduction of the profits taxed abroad in the cases determined by agreements concerning the prevention of double taxation.

574. There is another group of countries which hold national enterprises taxable on their total income from all sources, foreign as well as local, but grant certain relief in respect of income derived and taxed abroad. These countries include the United Kingdom, the Irish Free State, Canada, Belgium, the Netherlands (with regard to the income-tax on individuals), Netherlands East India, Germany, Danzig, Poland, the United States of America and Greece (in respect of its income tax on individuals). The United Kingdom and the Irish Free State have obviated questions of allocation as between their two territories by agreeing that individuals or companies resident in one State and deriving income from the other shall be taxed exclusively by the country of residence.¹

¹ Agreements of April 14th, 1926, and April 25th, 1928. For the former, see Section 23 of the United Kingdom Finance Act of 1926 and Part I of the Second Schedule to that Act. For the 1928 Agreement, see Section 21 of the United Kingdom Finance Act of 1928 and the Fourth Schedule of that Act. "Collection", C.345.M.102. 1928.II, pages 56, 58.

575. In order to assure relief to British enterprises operating in the Dominions, the United Kingdom laws, in respect of profits assessed to Dominion taxes, allows a deduction of either the Dominion rate of tax or half the United Kingdom rate, whichever is the lesser.¹ It is necessary, therefore, to determine the amount of Dominion profits in question. These are usually ascertained from the separate accounts of the Dominion establishment, but, in some cases, it is necessary to apply the "percentage of turnover" or other conventional methods described in connection with United Kingdom branches of foreign enterprises. Other conventional methods have been employed in the following cases :

(1) Banks. — The method most frequently adopted is to take such a proportion of the total profits as the Dominion assets bear to the total assets.

(2) Insurance Companies. — Where the Dominion profits cannot be satisfactorily ascertained from the accounts, owing to the activities of the taxpayer — for example, with regard to investments and reinsurance — it usually has been found satisfactory to take such a proportion of the total profits as the Dominion premiums bear to the total premiums.

(3) Transport Enterprises. — With regard to railways, the problem seldom arises, but, in a few instances, the profits have been divided between one State or province and another on a train-mileage basis. With regard to shipping profits, the profits arising at a particular Dominion port are usually ascertained by taking such a proportion of the total shipping profits of the enterprise as the freight receipts obtained at that particular port bear to the total freight receipts obtained for the accounting period.

576. Under the United Kingdom law, questions of allocation also arise in connection with a partnership, with some partners resident in the United Kingdom and some abroad, the income-tax liability being based on the United Kingdom profits plus a share of the foreign profits attributable to the partners resident in the United Kingdom. This necessitates a separate determination of the United Kingdom profits and the foreign profits, and, in most cases, it is effected on the basis of separate accounts, except where there are intricate interlocking transactions. If the separate profits cannot be readily ascertained, the "percentage of turnover" method might be employed.

577. Canada grants relief² against its tax on total net income, not only in respect of taxes paid to the United Kingdom or any of its self-governing colonies or dependencies in respect of income derived from sources therein, but also in respect of taxes paid to a foreign country, provided such foreign country, in imposing its tax, allows a similar credit to persons in receipt of income derived from sources within Canada. This deduction, however, may not exceed the amount of tax which would be payable under the Canadian Act in respect of said sources outside Canada, and it will not be allowed unless the taxpayer furnishes satisfactory evidence concerning the amount of tax paid and the particulars of the income derived abroad.

578. A Belgian enterprise is taxable on its total profits except that the part attributable to foreign sources is taxable at a reduced rate, and, in order to enjoy this reduction, the enterprise must submit, in addition to its annual declaration and general accounts, a balance-sheet and profit-and-loss statement pertaining to the income of each establishment situated abroad.³ The tax is imposed, however, on the total net profit of the enterprise, and there is no assessment if the enterprise as a whole realises no profit, even when income is shown in the books of a foreign branch.

¹ United Kingdom Finance Act, 1920, Section 27.

² Section 8 of the Canadian Income War Tax Act, Chapter 97, R.S.C. 1927, as amended.

³ Belgian Co-ordinated Laws, Article 54, paragraph 1, No. 3.

579. With regard to the Netherlands income tax on individuals, in order to determine income allocable to a foreign establishment which is exempt under certain conditions, the authorities follow the same methods as those described in determining the local income of foreign enterprises, with the exception that the law does not prescribe the use of the fractional and empirical methods described in connection with foreign enterprises, when assessing national insurance, railway and tramway enterprises. If an enterprise has in its assets shares of a foreign company, the dividends are attributable to the country of the real centre of management of the enterprise — *i.e.*, normally the Netherlands — and directors' percentages (*tantièmes*) and other remuneration distributed by other companies are considered as acquired in the country in which were effected the functions to which the *tantièmes* and remuneration correspond. If the enterprise carrying on its activities in the Netherlands extends its activities as well into another country where it realises a loss, the loss suffered in the foreign country will be deducted from the profits realised in the Netherlands, and the enterprise will therefore be exempt from tax in the foreign country, as well as be permitted to deduct the loss from the Netherlands profit.

580. Dutch companies, which are subject to the tax on dividends and *tantièmes*, pay this tax on one-third of the distributed income which corresponds to profits earned abroad, but no definite criteria have been prescribed for distinguishing between foreign and national income.¹ Likewise the Netherlands East Indian law does not prescribe criteria for determining income attributable to foreign sources in respect of which relief from double taxation may be granted, but the administration in practice would follow the same methods as those described in connection with foreign enterprises.

581. The Greek law grants a deduction for foreign taxes paid by national enterprises, including Greek companies, when the circumstances are such that they are taxed on profits instead of on their distributed income.² The authorities state that no important problems of allocation arise, because the deduction for the foreign tax on foreign income may not exceed the Greek tax, and, for this purpose, the administration proceeds to a verification in a manner analogous to that prescribed in connection with foreign enterprises.

582. Under various treaties, Germany, Danzig and Poland depart from their normal rule of taxing persons and companies domiciled within their territory on their total income from all sources by excluding from the assessment that part of the income which is ascribed to the establishment in the other contracting State. The profit allocable to the local establishment is usually computed by one or another of the methods previously described, unless it is necessary to effect an apportionment by means of a special agreement between the interested fiscal administrations.

583. The whole of the income of a national enterprise, without any allowance in respect of foreign income, is taxable in Roumania, Japan and Mexico. The same is true of the French and Greek taxes on dividends paid by national companies. Thus, the French "dividend" tax (*impôt sur le revenu des valeurs mobilières*) is imposed on the total amount paid in dividends or interest, regardless of the source, even though that part which is attributable to an establishment abroad is exempt from the profits tax (*impôt sur les bénéfices industriels et commerciaux*).³

584. In British India and Cuba, allocation questions are obviated to a certain extent by the underlying principles of the income-tax law. In British India, a resident is taxable on profits

¹ Law of January 5th. 1918, Articles 27 and 28.

² *Supra*, paragraph 405.

³ See, however, *infra*, paragraph 595.

arising, accruing or received in British India and on profits arising or accruing out of British India only if they relate to business and are brought into British India within three years of the year of origin. If the profits, although accruing or received abroad, are received in the first instance in British India, then they are taxable when received, whatever the nature of the foreign source of the income. Consequently, questions of allocation seldom arise, but, if they arose, they would be dealt with in very much the same manner as that described with regard to allocating income between the local branches of foreign enterprises. A Cuban enterprise is not taxable on foreign profits except those derived out of payments made abroad by persons domiciled in Cuba.

585. Spain and the Swiss cantons, both of which normally employ fractional apportionment, grant allowances if income attributable to foreign branches has been taxed abroad. A Spanish company, nevertheless, has to pay tax on at least one-third of its profit, because of its Spanish nationality. A company organised in a foreign State would not be subject to this minimum quota, even though it had its real centre of management in Spain. The allocation as between the foreign branches and the Spanish establishment is effected in accordance with the same rules as those described when dealing with foreign enterprises — *i.e.*, in accordance with their relative importance. The Swiss cantons, to reduce or prevent double taxation, either remit all or part of the tax relating to foreign income. For this purpose, Basle, Geneva and Zurich apply the method of fractional apportionment; Geneva and Zurich in every case levying a given part of the tax which the enterprise would have to pay if it were liable to tax on the whole of its income. Geneva fixes this part at a-half, Zurich at a-third. Berne grants certain abatements which are fixed in accordance with the circumstances of each case.

586. Except for the personal income taxes of Massachusetts and New York which are levied on the total net business income of residents, Wisconsin, Massachusetts and New York limit their respective taxes to that part of the income of domestic enterprises which is attributable to the establishments within their territory, and this income is determined in accordance with the same rules as those described above in treating foreign enterprises. In other words, the Wisconsin enterprise is taxed on its home profits in accordance with its separate accounts, if satisfactory, and otherwise by application of the allocation fraction. For the purpose of the Massachusetts corporate excise tax, the items allocable entirely to Massachusetts are interest and dividends, which are included in net income, gains from the sale of intangible assets wherever sold and gains from the sale of tangible personal property and real estate situated in Massachusetts. Other income is apportioned by applying the allocating percentage previously described, or in accordance with some alternative method accepted by the administration. New York corporations are subject to the franchise tax on the income allocable to New York, either by use of the prescribed formula or some other method selected by the tax commission.

ALLOCATION OF PROFIT TO REAL CENTRE OF MANAGEMENT WITHIN THE COUNTRY.

587. When a company has its real centre of management in a given State and its other operations — for example, manufacture — in another country, the general rule is not to ascribe any profits to the real centre of management as such. By way of exception, the Swiss cantons allocate a fraction of the total net profit to the seat of the enterprise which usually coincides with the real centre of management. This fraction is a percentage of the total net profit which varies in accordance with the functional importance of the seat and, as a rule, is not less than 10 per cent nor more than 30 per cent. There is an important group of countries, furthermore, which subject a company having its fiscal domicile or residence within its territory to tax on the total net income from all sources, foreign as well as national. In this case, however, the whole profit is allocated to the real centre of management in accordance with the principle of domicile rather than

for the purpose of rewarding management as such. This group includes : the United Kingdom, Canada,¹ Danzig, Sweden, Germany, the Irish Free State, Japan and Poland.

588. The countries which do not ascribe any part to the real centre of management as such include : Mexico and the United States (which tax a company organised in their respective territories on its total income without regard to the allocation of the real centre of management) and Belgium, Cuba, Denmark, Estonia, France, Greece, Hungary, British India, Italy, Latvia, the Netherlands, Netherlands East India, Roumania, Wisconsin, Massachusetts and New York.

589. Likewise, South Africa does not allocate to the real centre of management within the Union any portion of profit made by operations completed outside the Union, but, if any transactions were completed at the centre of management, the income would be taxable even though the transactions concerned matters or events outside the Union. For example, a whaling company with its head office and control within the Union carried out whaling operations in the Southern Seas, those operations being based on an island outside the borders of the Union. The whales were captured on the high seas, and the oil was rendered down on a floating factory moored at the island base. When the floating factory was fully laden, it proceeded direct to Europe, where the oil was sold by an employee of the company, who had there a permanent establishment. It was held that the profit arising from the manufacture and disposal of the oil arose from sources outside the Union. But when one of the floating factories was lost at sea and the company recovered under a policy of insurance entered into at the real centre of management in the Union the value of the oil carried by the factory, it was held that the proceeds of the policy were derived from Union sources, as flowing from the contract of insurance entered into within the Union.²

590. Certain countries preserve a minimum quota of the net profit of national companies for income-tax purposes as has been indicated above, but this allotment is considered a national charge rather than a reward for management. These countries include: Austria, Czechoslovakia, Hungary (in its treaty with Austria), and Spain. In the last-named country, this minimum quota of one-third is specifically applicable only to companies organised under Spanish law. It is interesting to note, however, that if a company organised in another State had its real centre of management in Spain, it would be taxable on a fraction of total net income determined in the ratio of its importance, as has been described above in treating foreign companies.

591. The dividend taxes of France and Greece are imposed on the income distributed, regardless of its source, by national companies, the test of nationality being the location of the statutory seat (*siège social*) within its territory which usually coincides with the real centre of management.

592. An exposition of this question is found in the Italian report. Originally, the theory that the entire income of an Italian enterprise was taxable at the central seat in Italy prevailed in the jurisprudence. It was considered that the seat at which the direction and administration of the enterprise are exercised is the very place where is found the centre of the whole activity, and therefore the place at which the income is produced, because the income results directly from the activity of the enterprise. The Court of Cassation³ decided that income should be considered as produced

¹ Nevertheless, no tax is imposed on "the income of incorporated companies whose business and assets are carried on and situate entirely outside Canada". Section 4(*h*) of the Canadian Income War Tax Act, Chapter 97, R.S.C. 1927, as amended.

² 3 S.A. Tax Cases 136, decision of special court for hearing income-tax appeals.

³ Judgment of June 30th-August 6th, 1925, Italian Jurisprudence, Vol. LXXVII, 1925, page 1936, Unione Tipografica Editrice Torinese, Turin, 1925.

in the place where the factors of production are situated and where are accomplished all the acts from which the income results, regardless of the place in which is situated the individual or the enterprise in whose interest the income is produced. Nevertheless, the fiscal administration did not accept this principle enunciated by the Court of Cassation. It considered that the court had committed the error of regarding as exclusive factors of production the material operations of manufacture and sale, but did not include among these factors the direction and administration of the enterprise. It is impossible to doubt that the direction and administration not only must figure among the factors of production, but they must even be considered as the essential factors of the material activity consisting in manufacture and sale, for the latter depend on the direction of the enterprise. In fact, it is the direction which organises, launches and sustains the other activities of the enterprise, with the result that, if the direction failed, the whole life of the enterprise would be interrupted.

593. Since the promulgation of the Law of August 12th, 1927, which exempts from the tax on movable wealth (*richesse mobilière*) the income realised abroad by branches having a regularly kept separate accounting, one may state that, in the absence of such accounting, the entire income is taxable at the central seat, but if an enterprise had only its seat in Italy and all its activities of production and sale at an establishment in another country which kept a regular separate accounting, only expenses would appear in the accounts of the central seat and all the income in the books of the foreign branch. Could a fraction of the income realised abroad be nevertheless attributed to the Italian seat? Could this fraction be subtracted from the income which is exempt under the Law of August 12th, 1927? This question has not yet been the subject of any court decision, and, consequently, the administration cannot foresee how the question would be solved.

CHAPTER XI.

HOLDING COMPANIES.

NATIONAL HOLDING COMPANIES CONTROLLING FOREIGN SUBSIDIARIES.

594. There are two types of holding companies to be considered : (1) those which are engaged in industrial and commercial activities as well as the holding of securities in other companies and which carry out some of the former class of activities through subsidiaries in foreign countries, and (2) those which are engaged exclusively in the holding of securities of other companies. Holding companies which carry out part of their industrial or commercial activities through subsidiaries abroad are subject to the same observations as those made above in connection with the allocation of income between national companies and foreign subsidiaries. Ordinarily, the fiscal administration of the country in which the holding company has its seat pays no attention to the foreign subsidiary unless profits are diverted to it through inter-company transactions. In such a case, the authorities either attempt to reallocate the profits as between the home company and the foreign subsidiary, as contemplated in Section 45 of the United States Revenue Act ; or the foreign subsidiary is regarded as a sham or simulacrum, and its profits are included in the assessment of the parent, as in the United Kingdom or the Irish Free State ; or the foreign subsidiary is included in the assessment of the parent on the grounds of its forming an economic unity with the latter, as in Germany. Under Spanish law, if a Spanish company controls a foreign company which operates exclusively abroad, the parent is regarded as doing that business itself, and the jury assimilates the foreign subsidiary to a branch and makes the assessment accordingly.

595 Various countries have specific provisions for relieving national companies with foreign subsidiaries from duplicate taxation. Thus, Austria, in principle, taxes an Austrian holding company on its dividend or interest income received from other companies, whether Austrian or foreign, but if it holds at least one-fifth of the shares of another company, and meets other conditions with regard to the duration of the holding and the close relationship between the two companies, then it is taxable only on a-fifth of the income received from such other company. Under the requirements of the French tax on income from securities (*impôt sur le revenu des valeurs mobilières*), dividends and interest received by the French company from a foreign subsidiary are taxed when received by the French company and again, by withholding at source, when this income is distributed in the form of dividends and interest. In order to prevent this double imposition of the same tax in respect of the same income, a provision has been enacted which exempts, under certain conditions, the dividends distributed by the French company out of interest or dividends received by it during the same fiscal year on registered bonds or shares held in the foreign company and subject to the French tax.¹ This provision is analogous to another according, under

¹ Law of July 31st, 1920, Article 27, and Law of July 31st, 1929, Article 4 : " Taxation of Foreign and National Enterprises ", Vol. I, page 93.

certain conditions, an exemption for dividends paid by the French company out of dividends or interest received from a French subsidiary.

596. A corporation, organised in the United States but owning a majority of the voting-stock of a foreign corporation from which it receives dividends paid out of income from foreign sources, may claim a credit against the American tax in respect of a certain proportion of the foreign income out of which the dividends are paid.¹ The purpose of this provision is to permit the American corporation, which finds it necessary to carry on business in a foreign country through a local company rather than a branch of its own organisation, to claim a credit which is fairly similar to that allowed in respect of taxes paid on the profits of the branch.²

597. In general, the holding company in the strict sense — that is to say, one which merely holds stocks or bonds of other companies, is taxable as any other national company on its income, inclusive of dividends and interest from such securities. Well-known exceptions to this rule are Danzig, Luxemburg and the Swiss cantons. Danzig exempts holding companies. Luxemburg taxes trusts engaged in commercial operations in the same manner as other companies, but exempts holding companies which are engaged solely in effecting financial operations and not in industrial activity nor have a commercial establishment open to the public.³ Various Swiss cantons accord national holding companies privileged treatment as compared with other companies. This treatment is granted impartially to foreign companies holding stock in Swiss subsidiaries and Swiss holding companies holding the securities of foreign companies. The fiscal privileges vary with the canton — some grant a reduction of the normal tax, others exempt the profits and apply a reduced rate to the capital of the company.⁴

598. The countries which submit national holding companies to the same regime as that applicable to other national companies include : the United Kingdom, the Irish Free State, Canada, South Africa, Belgium, the Netherlands, Netherlands East India, Spain, Denmark, Sweden, Germany, Hungary, Roumania, Japan, Cuba, Mexico and the United States. Thus the United Kingdom authorities assess a British holding company in respect of its own profits including dividends received from a foreign subsidiary. The Belgian law requires that a holding company must keep accounts showing its foreign and local income. The dividends and interest received in Belgium are subject to the *taxe mobilière* by withholding at the source at the full rate and those from abroad which are paid in Belgium at a reduced rate. Income received abroad must be declared by the holding company which pays tax at the reduced rate thereon. This income is not again taxable, and the net amount may be added to the reserves or distributed as dividends to the shareholders in the holding company without being taxed again.

599. A holding company having its seat in Italy is subject to the tax on income from movable wealth (*impôt sur la richesse mobilière*) on all its income subject to the following :

(1) The holding company would not be taxed on dividends from shares in an Italian company, such income having been taxed as the profits of the latter, but dividends received from shares in a foreign company are included in its taxable income. In principle, if an Italian holding company is also engaged in industry or commerce and possesses abroad an autonomous subsidiary company, the dividends received from it are taxable unless the

¹ United States Revenue Act of 1932, Section 131(f) ; " Taxation of Foreign and National Enterprises ", Vol. I, page 227.

² Revenue Act of 1932, Section 131(a)(1) ; " Taxation of Foreign and National Enterprises ", Vol. I, pages 226 to 231.

³ Law of July 31st, 1929 ; " Taxation of Foreign and National Enterprises ", Vol. II, page 325 and 326.

⁴ " Taxation of Foreign and National Enterprises ", Vol. II, page 459.

administration exempts them in accordance with the principle contained in the law exempting the income derived by a foreign branch with a regular separate accounting.

(2) An Italian holding company is taxable on interest on bonds of other Italian companies, unless they were issued after September 30th, 1926, and also on bonds issued in Italy by a foreign company.

(3) An Italian holding company is taxable on income derived from speculative transactions in securities, whether foreign or Italian.

600. The Netherlands taxes a company on its distributed income, but a certain relief would be allowed in respect of that part of the amount distributed which is derived from holdings in foreign companies¹.

601. Germany taxes a national holding company on dividends and interest received from a foreign company. The same is true in Hungary : Roumania subjects the dividends and interest to the schedular tax on income from securities. The Japanese assessment of a national holding company includes dividends and interest. The same is true in Mexico and the United States of America.

602. British India taxes a holding company in the same way as any other national company on income arising, accruing or received in British India and on profits derived from business abroad remitted within three years of the year of origin. Cuba would tax a holding company on dividends and interest from abroad, if paid in Cuba. Estonia and Latvia report that they have no cases of this kind, and Poland would tax a holding company as a national company. Greece would do likewise.

603. Under the Wisconsin statute, there are no special provisions for holding companies, such enterprises being taxable on interest received and on the whole of the dividends received from foreign subsidiaries, unless 50 per cent of the income of the latter has been derived, and therefore taxed, in Wisconsin — in which case the whole of the dividend is exempt. Massachusetts would tax the holding company as described above in connection with Massachusetts corporations. New York has a special franchise tax, based on the amount of the capital stock in New York for corporations, the sold business of which consists in holding stock of other corporations for the purpose of controlling the management and affairs of such other corporations.

NATIONAL COMPANIES CONTROLLED BY FOREIGN HOLDING COMPANIES.

604. The general rule is that the national company is taxed as any other national company, in the manner described above, and the foreign holding company is subject to the same provisions as any other foreign company deriving dividends, interest or other income from a national company.²

Danzig, Luxemburg and the Swiss reports state that foreign holding companies are exempt from tax. By way of example, dividends and interest would be taxable by withholding at source when paid to a foreign holding company by a national company in the United Kingdom, the Irish Free State, Canada,³ Belgium, France, Roumania, Spain and Japan. In Cuba, tax is withheld,

¹ *Supra*, paragraph 580.

² For detailed provisions concerning the manner of taxing dividends, interest and the like, see Part II of the various national reports.

³ Except that the tax is not due in the case of a non-resident company beneficially owning all the shares (less directors' qualifying shares) of a Canadian company, provided not more than one-quarter of the gross income of the latter is derived from dividends and interest.

except in the case of dividends paid out of taxed profits. The foreign company would apparently be liable to tax on such income in Sweden, Estonia and Latvia, even though it were not withheld. In Switzerland, such payments would be subject to the federal coupon tax. Germany, Greece and Hungary require withholding of tax on dividends. British India, in addition to imposing ordinary income tax and company super-tax on the profits of the national company, imposes company super-tax on the parent company if the parent receives dividends in excess of 50,000 rupees. Withholding of tax from interest would take place in Italy,¹ Mexico and the United States. No tax would be withheld on either in the Netherlands, Denmark, Austria, Poland, South Africa (the recipient being a non-resident public company not carrying on business in the Union), Massachusetts, New York or Wisconsin. This exemption exists also in Netherlands East India, provided the non-resident has not in that country a business which invests its reserve funds in shares or bonds².

605. If the national company is engaged in carrying out industrial or commercial activities of a foreign holding company, the problems of allocation which may arise, especially if profits are shifted from one to the other, have already been discussed in connection with the allocation of income to the local subsidiaries of foreign enterprises.³

¹ It should, however, be noted that in Italy the Law of September 20th, 1926, exempts the bonds issued by Italian companies since September 30th, 1926, from the tax on income from movable wealth.

² "Taxation of Foreign and National Enterprises", Vol. III, page 159, paragraph 128.

³ *Supra*, paragraphs 384 *et seq.*

CHAPTER XII.

PREREQUISITES FOR A REGIME OF ALLOCATION.

SUMMARY OF SCOPE OF REGIME.

606. The preceding survey of the law and practice concerning the taxation of foreign and national enterprises reveals the scope and complexity of the problem of formulating a regime for preventing double taxation of the income of business enterprises. Inasmuch as the income of an enterprise, depending upon its nature, may include dividends, interest, patent and copyright royalties, rents from real estate and possibly mining royalties, remuneration for services rendered, gains from the purchase and sale of securities or of real estate, as well as profits from buying and selling goods, and/or producing or manufacturing goods and selling them, a complete solution of the problem of allocation presupposes an agreement between countries concerning jurisdiction of each of these items of income. Furthermore, it should overcome, in so far as possible, the difficulties encountered under existing laws.

607. The contention is unfounded that uniform principles of allocation are impossible because of fiscal regimes having to conform to the different economic circumstances of the various States. This survey reveals that the essential legal principles of allocation are much the same in most countries, although the methods used in applying them reflect the distinctive nature of their people. Moreover, the westward trend of industrial development from Europe across the Americas to the Orient, bringing the factory nearer the plantation or mine, and resulting in new accumulations of capital, tends in the course of time to give all parts of the world much the same economic complexion.

PRINCIPLES OF FISCAL JURISDICTION.

608. It is impossible to formulate a general regime of allocation without establishing uniform principles of jurisdiction, and this involves the modification of the fundamental provisions regulating liability in some tax laws and the placing of limitations on such provisions in other laws. Briefly, it entails abandoning all precepts of liability other than those of fiscal domicile and source, and requires that the concept of fiscal domicile be uniformly defined and that the concept of source be defined and strictly limited to sources obviously within the jurisdiction of the State. This precludes the telescopic extension of the concept of source in order to trace profits through corporations created under the laws of another country ; or reaching income derived from a source in a foreign country by a corporation created or domiciled in the same or a second foreign country, because of some remote economic relation that it is deemed to have with a source in the taxing State ; or deeming by statutory presumption all income derived from a business connection or sale within the State, regardless of the nature of establishments abroad which have handled the goods, to arise exclusively within the taxing country. In other words, a State should tax a foreign corporation

only in respect of income from sources clearly within its territory, and thereby avoid transgressing the jurisdiction of another State over sources of income definitely within its territory.

609. If an item of income can thereby be attributed to one definite source, only two States can claim jurisdiction — the country in which the source of the income is located and the country in which the taxpayer has his fiscal domicile. The allocation of the item of income to a definite source prevents the double taxation which results from conflicting claims of countries of source. The double taxation which results from the country of domicile taxing total net income inclusive of that taxed by a country of source can be prevented only by imposing limitations on the jurisdiction of one or both countries.

610. The question of fiscal jurisdiction has already been settled to a large degree by the tax laws and jurisprudence of a number of countries, by bilateral conventions for the prevention of double taxation,¹ and proposals for its solution are found in the model Conventions for the prevention of double taxation adopted at the General Meeting of Governmental Experts in Geneva, 1928.² In substance, this question of jurisdiction is settled by employing only two principles of liability — those of source and fiscal domicile. The principles of taxation at the place of receipt or the place of payment are therefore eliminated. Moreover, the sources mentioned are the immediate sources of income and are not subject to extra-territorial extensions because of a business connection, economic relations or control through ownership of stock in a local company.

611. Under existing law, some countries claim jurisdiction over the entire income of persons (natural or legal) domiciled or resident within their territory, and others over all or part of the entire income of citizens of, or corporations created or having their statutory seat in, the country, regardless of how much of the income is derived from sources in another State.³ Because of these conflicting principles, a taxpayer may be fully liable to tax in two or more jurisdictions. For example, a corporation created in one country may have its fiscal domicile in another according to the law of the latter. This question of double or triple domicile is not important in practice, because the taxpayer can legally arrange to avoid it; but when establishing a regime to prevent double taxation, the prevention of such conflicts by adopting one criterion should be considered. The General Meeting of Governmental Experts, 1928,⁴ adopted as the test of fiscal domicile for all types of business enterprises, whether belonging to an individual, a partnership or a corporation, the place where the real centre of management is situated. The real centre of management will, of course, coincide with the statutory seat as a general rule, but, if it is situated in a different place, then the location of the real centre of management determines fiscal domicile. This concept coincides with the British criterion of "central management and control", but obviously conflicts with the existing criteria in many countries. If it is impossible at the present time to secure agreement as to the fundamental criterion of fiscal domicile, Dr. T. S. Adams has suggested that double taxation could be greatly reduced if each country which taxes the total net income of a corporation because of its being created, or having its statutory seat or real centre of management within the country, would regard the other country, which claims taxation on total net income on one of the other grounds, as a country of source, and give a credit against its tax in respect of taxes paid at such source.

612. The question of a uniform definition of fiscal domicile for individuals is apparently of secondary importance in the case of a business enterprise owned by an individual or partnership, as the major test of the place where the real centre of management is situated would be definitive

¹ "Collection".

² League of Nations document C.562.M.178.1928.II, "Double Taxation and Tax Evasion".

³ *Supra*, paragraphs 567 *et seq.*

⁴ League of Nations document C.562.M.178.1928.II; Convention No. 1a, Article 5 at page 8; Convention No. 1b, Article 2B at page 16; Convention No. 1c, Article 3 at page 19.

for the enterprise itself.¹ As regards the individual owner or partner himself, his fiscal domicile is defined by the General Meeting of Governmental Experts as the place where he has his permanent home, and, if he has such a home in two or more countries, liability is prorated on the basis of the time spent in each, or by agreement between the competent administrations.²

613. To prevent the double taxation resulting from the conflicting claims of the country of domicile and the country of source, obviously one country or the other must restrict its jurisdiction or both must make concessions. There has been no uniformity in the methods of relief, because there is no uniformity in the tax systems concerned. The systems are so different, even in their general structure and underlying theories, that an accurate and simple classification is impossible. Speaking in the broadest terms, there are three general types of systems : (1) Systems which are composed of a graduated tax on the total net income of resident individuals, which is superimposed upon schedular or impersonal taxes levied in respect of income from separate sources — *e.g.*, real estate, income from loans and securities, compensation for work, and income from a business establishment. Provisions differ as to whether these sources are purely territorial or whether the schedular tax should be imposed on resident taxpayers in respect of income from similar foreign sources as well. (2) Systems consisting of a graduated tax on individuals and a flat rate tax on corporations, both imposed on the total net income regardless of source if the individual is a resident or a citizen or if a corporation is resident or organised within the country ; and the same rates are imposed in respect of income from local sources if the individual is a non-resident or if the corporation is non-resident or organised under the laws of a foreign country. When the tax is levied on non-residents in respect of income from local sources, the provisions vary as to whether tax shall be withheld at source — for example, from dividends, interest and royalties — and whether the tax is on the gross amount of the individual item of income or whether all or certain items are to be lumped together in order to compute the tax on net income from local sources. (3) Systems which tax primarily income from local sources regardless of where the taxpayer is resident and regardless of his nationality, and the tax is generally withheld at source when possible.³

614. In some legislative provisions to prevent double taxation, the country of domicile or nationality allows a certain deduction from its tax in respect of taxes paid abroad on foreign income.⁴ Except for the treaty between the United Kingdom and the Irish Free State,⁵ which provides for the reciprocal exemption of all kinds of income at source in order that it may be taxed exclusively at domicile, the treaties⁶ that have been concluded deal with the principal categories of income separately. These treaties are fairly well typified by the model conventions to prevent double taxation drafted at the 1928 General Meeting of Governmental Experts⁷. Convention 1a is intended to serve as a standard for agreements between countries for tax systems which are primarily in the first category listed above and provides, broadly speaking, that only the country of fiscal domicile of an individual may subject him to its general personal tax, whereas only the country

¹ The draft treaties are not clear as to whether the profits of such enterprise are to be taxed at the real centre of management and the individual's or partner's income again at their fiscal domicile if it is in a different country. If each is taxed separately, double taxation would result, but the Convention may presuppose the application of the provision in many tax laws that, although the seat of the enterprise might report total income, the distributable share of the individual or partner would be taxed in accordance with his status as resident or non-resident.

² *Ibid.*, Convention No. 1a, Articles 10 and 11 at pages 9 and 10 ; Convention No. 1b, Article 1 at page 16 ; Convention No. 1c, Article 7.

³ See "Taxation of Foreign and National Enterprises", Parts I and II of the National Reports.

⁴ "Collection".

⁵ Agreement between the British Government and the Government of the Irish Free State in respect of double income tax, April 14th, 1926, as amended by the Agreement of April 25th, 1928, "Collection", pages 56 to 60.

⁶ "Collection".

⁷ League of Nations document C.562.M.178.1928.II.

in which the direct source of a class of income is situated can impose a schedular tax thereon. Countries with taxes in the second category listed above were included in the advocates of Convention 1*b*, which recognises the principle of taxing total net income by the country of domicile, subject to allowing against this tax a credit for taxes paid in the other contracting State in respect of income from specified sources. For countries which are partly in the second category and partly in the third, model Convention 1*c* may prove suitable : it allocates practically all important classes of income for taxation exclusively at source, except that it recognises the principle of taxing income from securities at domicile, subject to giving certain relief for a source tax in case one is levied, and contains a basket clause allocating all items of income not specifically mentioned to the country of domicile.

615. Although the measure of relief from double taxation needs no further consideration in elaborating a regime of allocation, the general procedure followed in these treaties is significant. Briefly, it consists in classifying items of income in accordance with their respective sources and stipulating the extent to which each country is to restrict its jurisdiction so as to prevent the double taxation of each item.

616. Although the model conventions embody different systems of relief in general and also in respect of definite items of income, they all contain the same fundamental criterion regarding income from an industrial or commercial enterprise — namely, that the primary right to tax belongs to the country in which is situated the permanent establishment which produces the income. A regime of allocation for business income may be based upon this general proposition regardless of the nature of a country's tax.¹ Once the income has been allocated, relief from double taxation can be effected in the manner agreed upon by the parties concerned. In view of the fact, however, that the income shown in the books of an enterprise or any one of its branches may include items from sources distinguishable from the industrial, mercantile or other operations which constitute its business — for example, such items as interest on bonds or dividends on shares which have been purchased with reserve funds, as royalties paid in respect of patents or copyrights which have been licensed to outsiders, provision must be made for segregating such items and allocating them to their respective sources, together with the items of expense related thereto, in order to isolate business income. If the business of the enterprise is to deal in real estate, securities, patents or copyrights, or other property which is a source of income, there may be an apparent conflict of jurisdiction in many cases between the country in which such property is situated and the country in which the establishment which deals in such property is situated. Thus, real estate which is situated in country A may be bought and sold by an establishment in country B ; or bonds or shares of stock issued by a company with its real centre of management in country A may be bought and sold by a brokerage house in country B ; again, patents or copyrights issued in country A to an inventor or author resident in country B may be bought and sold by an establishment in country C. Is one rule to cover the taxation of income from such property and another to govern gains from trading in such property with the result that the same piece of property would give rise to claims by two countries on grounds of source ? It is logical to recognise the two sources of income, but desirable, in so far as real estate is concerned, to regard both sources as being in the country where the real estate is situated. Income from dealings in personal property can be allocated to the establishment effecting them, even though the *situs* of the property itself may be viewed as a source of income in another jurisdiction.

617. The prerequisite obviously is agreement concerning the source to which income, and related expense, is to be allocated, thus separating the items which are assignable to one definite source from those which are attributable to two or more sources in different jurisdictions and

¹ *Supra*, paragraph 613.

therefore have to be allocated or apportioned between the interested countries in some appropriate manner. Once an item of income is allocated to its definite source, it may be taxed — if not already taxed by withholding — or exempted in accordance with the legislation of that country or treaties to prevent double taxation. In any event, the allocation of each item of income to a definite source obviates double taxation on grounds of source, and the allocation of expenses incurred in obtaining such income to the same source precludes the deduction of the same item of expense in more than one country.

618. The following precepts of source are observed by the majority of countries and to a certain extent in the model conventions :

1. The source of income from real estate, including rentals and royalties, is the country in which the real estate is situated ;

2. The source of interest on mortgages, not represented by corporation bonds, is the country in which the mortgaged real estate is situated ;

3. The source of interest on bonds issued by a company, whether secured on a piece of real estate or on the general assets of the company, is the seat or real centre of management of the company ;

4. The source of interest on other loans in general is the residence of the debtor — *e.g.*, the seat or real centre of management of a company ; but, if the money is borrowed by the seat for the use of a particular establishment in another country, or by such establishment, then the latter is the source ;

5. The source of dividends is the seat, or real centre of management, of the company paying them ;

6. The source of compensation for services is the country in which the services were rendered ;

7. The source of rentals or royalties arising from personal property (*e.g.*, leasing a machine), or from any interest in such property, is the country in which such property is situated, and the source of rentals or royalties for the use of, or the privilege of using in a country, patents, copyrights, secret processes and formulæ, goodwill, trade marks, trade brands, franchises, and other like property is the country in which such property is used. The application of these principles is generally facilitated by the fact that the residence of the lessee or licensee is in the country where the personal property is situated or used. If the property is in a country other than one in which the lessee or licensee has a permanent establishment which uses the property, then the residence of the debtor of the income may be regarded as the source ;

8. The source of income from the purchase and sale of real estate is the country in which the real estate is situated ;

9. The source of income from the purchase and sale of securities or other intangible personal property, such as patents or copyrights, is the country in which the sale takes place ;

10. The source of income from the purchase and sale, or production and sale, both within the same country, of other personal property (for example, raw materials, machines and merchandise) is the country in which such transaction was effected ;

11. In general, the source of income from carrying on an industry, commerce or profession of any kind is the establishment at which the income was produced. If the income was produced by the joint activities of establishments in two or more countries, the application of this principle presents the problem of allocating business income — *i.e.*, determining which establishments are productive of income and how much is attributable to each.

WHERE INCOME ACCRUES OR ARISES.

619. The key provisions to the whole study of allocation or apportionment of business income are found in draft Convention No. 1a, Articles 5 and 7, which deal with schedular taxes, and

similar provisions are contained in draft Convention No. 1b, Article 2, B and D, and draft Convention No. 1c, Articles 3 and 5, which refer to any kind of tax levied on the income in question. These articles are essentially the same¹ and the pertinent provisions in draft Convention No. 1a² read as follows :

“ Article 5. — Income, not referred to in Article 7, from any industrial, commercial, or agricultural undertakings and from any other trades or professions shall be taxable in the State in which the permanent establishments are situated.

“ The real centres of management, branches, mining and oil fields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a *bona-fide* agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country.

“ Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory. The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment.

“ Nevertheless, income from maritime shipping and air navigation concerns shall be taxable only in the State in which the real centre of management is situated.

“ Article 7. — Salaries, wages or other remunerations of any kind shall be taxable in the State in which the recipients carry on their employment. . . .”

620. The commentary to draft Convention No. 1a³ states that the word “ undertakings ” must be “ understood in its widest sense without making any distinction between natural and legal persons ”. It also explains that the establishments listed are considered as permanent whether they “ are used by the traders themselves, by their partners, attorneys or their other permanent representatives . . . ” The words “ *bona-fide* agent of independent status ” are intended to imply absolute independence both from the legal and economic points of view. The agent’s remuneration must not be below what would be regarded as a normal remuneration. The Committee has not expressed an opinion on the point whether purchasing offices or sales offices and plants are to be considered as places of business, this being a question of fact.

621. In order to draw a more clear-cut distinction between a permanent establishment and an autonomous agent, through whom business may be done without incurring tax liability, the Fiscal Committee, after examining existing law and practice in representative countries, drafted a definition of the term “ autonomous agent ” in relation to the term “ permanent establishment ” as follows :

“ The fundamental principle is :

“ When a foreign enterprise regularly has business relations in a country through an agent established there who is authorised to act on its behalf, it shall be deemed to have a permanent establishment in that country.

“ A permanent establishment will thus exist when the agent, being established in the country :

“ (a) Is a duly accredited agent (*fondé de pouvoir*), who habitually enters into contracts on behalf of the enterprise for which he works ; or

¹ A substantially similar provision is found in the code of principles for eliminating double taxation contained in the Annex to Resolution I passed at the Amsterdam Congress of the International Chamber of Commerce, July 8th to 13th, 1929 ; Supplement No. I to *World Trade*, October 1929.

² League of Nations document C.562.M.178.1928.II, page 7.

³ Document C.562.M.178.1928.II, page 12.

“(b) Is bound by an employment contract and habitually transacts commercial business on behalf of the enterprise in return for remuneration from the enterprise ; or

“(c) Is habitually in possession, for the purposes of sale, of a depot or a stock of goods belonging to the enterprise.

“As evidence of the existence of an employment contract under the terms of (b) may be taken, moreover, the fact that the administrative expenses of the agent, in particular the rent of premises, are paid by the enterprise or the fact that the latter’s intervention is manifested by outward signs.

“A broker who places his services at the disposal of an enterprise in order to bring it into touch with customers does not in his own person constitute a permanent establishment of the enterprise, even if his work for the enterprise is to a certain extent continuous or is carried on at regular periods.

“Similarly, the fact that the commission agent (*commissionnaire*) acts in his own name for one or more enterprises, and receives the normal rate of commission, does not in principle imply the existence of a permanent establishment for any of those enterprises. This may not be the case, however, if he is required to devote the whole of his activities to a single enterprise.

“Lastly, there cannot be held to be any permanent establishment in the case of commercial travellers not coming under any of the above-mentioned categories.”¹

622. As the purpose of a treaty to prevent double taxation is to limit the taxing power of the State and not to impose liability, which is a function of the State’s legislature, it is evident that the effect of Article 5 would be to free the enterprise from taxation in a contracting State where it has no permanent establishment and leave it subject to the internal law of the State in which it has a permanent establishment as defined. The provision thus exempts the taxpayer from casual or occasional transactions in a State in which he has no permanent establishment, presupposing that income derived from such transactions will be taxed at the permanent establishment of the enterprise in another contracting State which effected the transaction through a broker or other autonomous agent in the first country, or through its own travelling representative. Under the existing law of various countries, the mere possession in the territory of such countries of a permanent establishment, such as most, if not all, of the establishments listed, does not in itself entail liability to the income tax.² Legislative provisions concerning where and when income arises or accrues differ greatly, and as a consequence income might accrue to a particular type of establishment in one country, whereas it would not to the same type of establishment in another. This is not to be criticised, however, as each country has the sovereign right to determine which items of income from local sources are subject to its tax. The list of permanent establishments does not specifically include all types of establishments at which income might be produced under the law of the country concerned, notably plantations of agricultural enterprises, and many of the treaties between European countries which embody the criterion of permanent establishment have defined it somewhat differently.³

¹ Report on second session of the Fiscal Committee (document C.340.M.140.1930.II) ; also confirmation by third session of Fiscal Committee (document C.415.M.171.1931.II.A).

² See “Taxation of Foreign and National Enterprises”, Parts I and II of National Reports, and *supra*, paragraphs 27 to 29.

³ “Collection” ; see also the treaty between France and the United States, mentioned *supra*, paragraph 404, footnote 3.

SUBSIDIARIES TREATED AS INDEPENDENT ENTERPRISES.

623. It is evident from the tenor of Article 5 and its commentary that the term "undertaking" or enterprise includes, when referring to a corporation, merely the corporate entity and its own branches, forming a part of the single corporate entity, and does not include subsidiary corporations organised in the same or other countries which are themselves separate legal entities, or affiliated corporations which are not controlled by the first-mentioned corporation itself, but are owned or controlled by the same interests as those which control the first-mentioned corporation¹. Although some corporations carry out their activities in foreign countries through branches of their own organisation, many corporations find it expedient to organise subsidiary companies under the laws of each foreign country in which they have property or a market of any importance. Moreover, they sometimes organise in the home country subsidiaries, each of which is devoted exclusively to the production of one of its major products, and sometimes the handling of exports to foreign countries is centralised in an especially formed export corporation. Each of these units is a separate legal entity and should derive a separate income. Each of such units performs functions which might be carried out by a branch of the parent corporation itself.

624. The fundamental legal difference, however, is that each transaction between the parent company and a subsidiary company, or between two subsidiaries, should be carried out as a legal transaction between independent enterprises, whereas if the corporation carries out its activities through its own branch or branches, it does not generally in practice, nor in law, make contracts with or between such component parts of its own organisation. Strictly speaking, therefore, if a corporation produces goods at its own factory in one country and sells the goods at its branch in a second, the corporation does not realise any profit until the goods have been sold to outsiders. This is true even though the goods were billed from the factory to the branch at the independent factory price used in billing goods to outside dealers. If the branch does not sell the goods, or sells them at a loss, an adjustment can be made in the accounts of the factory, and the corporation reports its income as only the amount actually derived from sales to outsiders.

625. On the contrary, if a corporation manufactures goods at its home factory and sells them to an independent corporation which in turn resells the goods for its own account, the second corporation must pay the first corporation for the goods, and if it does not resell the goods or sells them at a loss, it must bear the loss. If the second corporation is a subsidiary or affiliated company of the former, strictly speaking the situation should be the same.

626. In law, a taxable profit might accrue to the producing corporation if title to the goods were transferred to the selling corporation. In economic fact, no profit accrues to the enterprise consisting of the producing corporation and the selling corporation, until the goods have been sold by the selling corporation to outsiders. The same is true if a subsidiary mining company in Mexico extracts ores which are shipped to a second subsidiary company in the United States for transformation into sheet metal, which in turn is shipped to a third subsidiary for manufacture into machines, and the machines are subsequently transferred through an export corporation in New York to a selling subsidiary in another country. Nevertheless, under its tax laws Mexico will assess its tax on the income accruing to the mining company, the United States will tax the income accruing to all or each of the corporations in the United States, depending upon the form of return,² and the other country will tax the profits arising or deemed to arise to the selling corporation.

¹ The code of principles for eliminating double taxation adopted by the International Chamber of Commerce, and mentioned *supra*, paragraph 619, footnote, specifically excludes a subsidiary company from the definition of the term "permanent establishment".

² Revenue Act of June 6th., 1932, sections 52 and 141.

Economic fact must inevitably give way to the definite principles and provisions of law under which business is conducted.

627. In short, the very fact that a subsidiary company is formed to operate an establishment of any kind within a country gives rise to the necessity of carrying on business subject to the same legal requirements as any other corporate entity within the country. The subsidiary must ordinarily have an adequate capital, and the nature of its activities and its contractual relations with outsiders and other corporate units of the enterprise will determine its income. If its income is diverted to other units of the enterprise in any manner, the tax authorities, as a general rule, have only to examine the inter-company transactions, appraise their terms and results in the light of sound legal and business principles, or by comparison with independent companies engaged in similar activities under similar circumstances, and recapture any profit that may be shown to have been diverted. Obviously, if the diverted profit is retrieved after it has already been taxed as income of another unit, double taxation will result, unless the administration of the other country is willing to reduce its assessment and refund a proportionate amount of the tax.

628. As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities ; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.

BRANCHES ASSIMILATED TO INDEPENDENT ENTERPRISES.

629. Branch establishments, moreover, should be treated in so far as possible as independent entities, in order that the income allocated to a branch may be equivalent to that which would have been derived by an independent enterprise. The type of establishment which may most readily be treated as an independent enterprise is what is termed an " autonomous establishment ". Other establishments are quasi-autonomous, even though carrying on relations with other units of the enterprise. Others are so dependent on the rest of the enterprise that their activities must be viewed against the background of their relations with other establishments of the enterprise. Still other establishments are not in themselves productive of income, but they render services to the enterprise which effect savings or may result in income being realised elsewhere.

Autonomous Establishments.

630. There are many types of establishments which by the very nature of their activities may be considered as autonomous : an office which buys within a country and sells within the same country at regular market prices ; a factory which buys raw materials within the country or on world markets and sells the manufactured goods within the country at market prices ; a plantation, mine, oil well or similar establishment which produces goods within the country and sells them at world prices. In general, any establishment within a country which carries on activities begun and completed within the country or which purchases, produces and or sells goods, the price of which is determined by world market prices, should be considered as autonomous even though its management is conducted directly or indirectly by officers at the real centre of management in another country. There are many establishments of other types of enterprises which may readily be considered as autonomous ; for example, an establishment which sells services of any kind within a country, such as accounting or advising on technical matters ; a branch of a foreign bank which is subject to the rigid requirements for banking and bank examination by Government officials ; a

branch of a foreign insurance company which is subject to the specific requirements of insurance legislation ; an establishment supplying transportation, or communication by telegraph, wireless or radio, or supplying power, light or gas, which is subject to the control of a local public utilities commission or the terms of a concession ; an engineering project which uses materials bought within the country and is in every respect carried out within the country, although done by a foreign engineering company ; the operation of a mine, oil well, plantation, quarry or the extraction or production of natural products which are subject to the control of the local Government. The autonomy of such establishments is as a rule absolutely assured if they are incorporated under local laws and provided with an adequate capital. If by any chance the profits are diverted by means of excessive interest rates, royalties, charges for technical advice, engineering or other services, the fairness of these charges can readily be determined and excessive charges can be adjusted. Incidentally, in many countries there is little likelihood of such charges being made, because they are only allowed as a deduction to the local enterprise if subjected to the tax imposed on such income.¹ Furthermore, there are many establishments which, although carrying on transactions with other establishments of the enterprise in other countries, may readily be assimilated to autonomous establishments : an establishment which sells raw materials produced elsewhere by the enterprise at the same rate of commission as independent commission agents or brokers ; a refinery or other processing establishment which receives the same remuneration for its services from the enterprise as it does from outsider for similar services ; a purchasing establishment which receives the same commission for its purchases as that received by an independent purchasing agent. Many more examples could be cited of establishments which, though serving the enterprise in one capacity or another, may readily be assimilated to or regarded as autonomous establishments.

Dependent Establishments.

631. The more the income of an establishment becomes dependent upon the outcome of its relations with other establishments or subsidiaries of the enterprise, the more difficult become the problems of allocation. Such establishments include primarily branches which purchase and process raw materials, factories which receive such materials and transform them into finished articles, and sales establishments which market the finished products. In other words, establishments which create, add value to, or sell a product, the profit or loss of each of which awaits the eventual sale and depends to a greater or less degree upon the efficiency of the other establishments involved. Instead of there taking place in each country a transaction which under the terms of the law gives rise to taxable income, a series of operations is begun in one country which does not give rise to income until the goods have been sold in another. Such transactions take place as a general rule in connection with mining, agricultural, industrial and mercantile enterprises, and, as they present the greatest problems, appropriate principles and methods for allocating their income will be considered first. Banking and insurance enterprises and enterprises which render transport or communication services which are begun in one country and end in another present problems of allocation which have to be solved in accordance with entirely different methods, and will therefore be considered separately.

INDUSTRIAL AND MERCANTILE ENTERPRISES.

Principles of Allocation.

632. When income is derived from the purchase of goods in one country and their sale in another, or from the production, processing or manufacture of goods in one country and their sale in another, the theories under different systems of law conflict as to whether the place of sale is the exclusive source of income or whether the other country in which the goods have been bought or

¹ See Part II in National Reports in "Taxation of Foreign and National Enterprises".

produced or their value increased is likewise to be considered as a source and, if so, how much of the total income derived from the transaction should be ascribed to each. The problem is complicated further when an enterprise has establishments which do not produce or sell goods, but which contribute indirectly to the creation or sale thereof — for example, research establishments, statistical bureaux and display rooms. Moreover, no income may be actually received or realised at the real centre of management, yet the financial management, the determination of policies and possibly the technical management are carried out there, and have a direct influence on the realisation of profits at the various establishments.

633. In this connection, it is necessary to consider, *inter alia*, (a) where and when the income actually arises or accrues to the enterprise as a whole; (b) which types of establishments should be considered as productive of such income; (c) how is the expense of the unproductive establishments to be absorbed; (d) if a productive establishment in one country transfers goods to an establishment in another country, should a taxable profit be said to accrue to the first establishment, regardless of whether the enterprise subsequently realises a loss; (e) should the net profit of one establishment be set off against the net loss of the enterprise, and *vice versa*, — and (f) how is the profit of each establishment to be determined?

634. As the autonomous establishment of an industrial or commercial enterprise is readily assessable, attention will primarily be given to dependent establishments, which are involved in transactions with other establishments of the enterprise in discussing first the principle and later the methods of allocation. To facilitate the formulation of an allocation regime, only the general principles followed by the majority of countries will be stated; the exceptional rules can be found in the paragraphs mentioned in the footnotes.

635. *Selling Establishments.* — There is universal agreement that income arises or accrues to an enterprise at an establishment where sales are made to outsiders, and the majority of administrations consider that there should be allocated to a sales establishment only the profit that is attributable to selling, or, in other words, a sales or merchandising profit.¹ The great majority of countries distinguish between the sale of goods purchased abroad and the sale of goods manufactured abroad. In general, such countries make no allowance for a purchasing profit to the foreign establishment which purchased the goods and shipped them, without any processing, to the sales establishment. If, however the goods sold have been manufactured or produced abroad, their administrations generally allow the allocation of a reasonable manufacturing or production profit to the foreign establishment.

636. *Local Establishments selling abroad.* — If a local establishment of a foreign enterprise sells goods in a neighbouring country in which there is no permanent establishment of the enterprise, the majority of countries ascribe the profits arising from such sales to the establishment which effected them rather than to the real centre of management.²

637. *Producing Establishments.* — It is the general practice to assess a local manufacturing establishment of a foreign enterprise on the part of the profit attributable to manufacturing goods which are sold abroad.³ The taxable profit may be described as a manufacturing profit to distinguish it from the profit attributable to selling. As a rule, no profit is deemed to the enterprise from manufacturing in one country until the products shipped to the sales branch in another have been sold to customers.⁴

¹ *Supra*, paragraphs 416 to 428.

² *Supra*, paragraphs 429 to 435.

³ *Supra*, paragraphs 436 to 447.

⁴ The same principles apply to establishments producing raw materials which are shipped to establishments in other countries for further processing, manufacture or sale.

638. *Processing Establishments.* — If a foreign enterprise maintains an establishment in a country which processes materials purchased within the country, or shipped to it from an establishment within another country, and then transfers the processed materials to an establishment in a third country for further processing, manufacture or sale, the general practice is to ascribe an appropriate profit to the processing establishment.¹ Frequently, a processing establishment is assimilated to a manufacturing establishment, but in its more limited application the term includes sorting, grading, curing, ageing and any intermediate treatment between the creation or extraction of raw materials and the eventual fabrication or manufacture of the goods, wares or merchandise.

639. *Assembly Plants.* — The term “ processing establishment ” would not include an assembly plant in one country belonging to a company manufacturing automobiles or machines at its factory in another country, but the principle involved is much the same. Assembling is normally a part of the manufacturing process. If the manufacturing of the parts takes place in one country and the assembling thereof takes place in another, in principle it is appropriate to split the manufacturing profit between the two, but, if this is impracticable, the assembly plant could be allotted an appropriate remuneration for its services to the enterprise.

640. *Buying Establishments.* — In most countries, purchases of raw materials or other goods made by a foreign enterprise through a *bona-fide* commission agent or broker within a country are not subject to tax, but various countries endeavour to assess the foreign enterprise if it maintains its own office in the country for the purpose of making purchases there of goods which are shipped to its establishments in other countries for further processing, manufacture or sale. There are three theories underlying such a liability : (1) The carrying-on of business activities through an establishment is in itself sufficient to entail liability ; (2) the enterprise effects a saving through maintaining an employee in a buying office, equal to the difference between the commission it would pay to an independent purchasing agent and the salary and other expenses of the office itself ; (3) a part of the eventual profit realised is attributable to the conditions of purchase, or more precisely to skill, whether in buying at the lows (*au mieux*) in a fluctuating market or in selecting the articles purchased.² As we are dealing with income taxes, it is improper to assume that the maintenance of a buying office is in itself productive of income, but the determination of whether there is income should be based upon sound legal or economic principles. It is true that a saving may be effected through maintaining a buying office, but can a saving in itself be construed as taxable income when the goods themselves may subsequently be sold at a loss ? It is doubtful if it would be sound to recognise as a principle of tax liability the popular saying that “ a penny saved is a penny earned ”. In general, the saving effected through not spending or spending less is not susceptible of definite determination for income-tax purposes.

641. The theory that a part of the profit may be due to skill in purchasing might have weight if there were any practical way of measuring skill. A broad enquiry among business men and tax officials supports the conclusion that it is generally impossible to measure profits attributable to skill and that such gains, if any, are too evanescent. The buyer of an enterprise may be lucky enough to buy rubber, silk or other commodities at the low of the market once, twice, or over a period of weeks and months, but almost inevitably there comes a turn in his luck and for years he cannot do better than catch the average price or buy at prices higher than the average. Moreover, one may purchase at what appears to be a low price for the moment but have the misfortune to sell in another market at a still lower price, or the possible gains due to skill in buying raw materials may disappear after the articles have been manufactured and sold. Moreover, the profit realised by the person within the country who sells to the buying office will be taxable and, if the buyer

¹ *Supra*, paragraphs 448 to 450.

² *Supra*, paragraphs 451 to 460.

is assumed to make a profit on the purchase, the tax will be imposed twice in respect of the same transaction. It is clear that, as a general rule, countries should favour rather than burden foreign enterprises which open offices for the purpose of buying and exporting their goods, and consequently no profit should be allocated to an office which merely purchases goods for the purpose of supplying other establishments of the same enterprise.

642. One exception may be made to this rule to govern a trading enterprise which carries on speculative transactions in raw materials, maintaining offices for this purpose in two or more countries which alternately buy and sell or sell and buy such materials. In cases where it is impossible to follow through each transaction and determine where the income arose, the profits might be divided equally between the interested establishments.

643. *Establishments buying and processing.* — A distinction should be made between mere buying offices which purchase goods for exportation in the same condition as when purchased, and offices which maintain a large organisation for purchasing raw materials from the small producers within the interior of the country, sometimes making advances on the expected crops, and then collect the materials, sort and grade them in their own warehouses and sometimes process them to a certain extent before packing and shipping them. Such an establishment adds value to the purchased goods, and a commensurate income should be ascribed to its activities, which may be assimilated to manufacture. If this establishment is the principal establishment and the only other is a sales office at some world exchange, clearly the bulk of the income should be ascribed to the former.¹

644. *Research and Statistical Bureaux, Display Rooms, etc.* — Large enterprises often maintain establishments which do not produce, add value to, or sell goods, or sell services and therefore contribute only indirectly to the realisation of profits. For example, an enterprise may maintain a research establishment which develops new inventions or processes or methods of production, which some day may or may not be used. They work exclusively for the enterprise, and in themselves represent only expense to the enterprise. The invention perfected in a given year may represent years of effort, and more years may elapse before the article is placed on the market, or the machine is installed in the factory, or the process introduced. The value of the machine or the process, if successful, may be difficult to measure in terms of income. It may prove valueless and be scrapped almost at once. If the new invention sells, the results are reflected at the sales establishments. It hardly seems feasible to ascribe any profit to a research establishment, but its cost should be included in overhead and distributed in some appropriate manner. If a research establishment renders services to outsiders for which it receives compensation, such income should of course be taxable in the country of such establishment.

645. What has been said of research establishments applies equally well to offices that are sometimes installed in a central city for the purpose of gathering statistics on the production or consumption of competing articles, or probable sales in the local or neighbouring markets. Obviously such an establishment is in itself only an item of expense, and its services can hardly be evaluated in terms of income. If its services are effectual, the results are shown at the sales establishments of the enterprise. Sometimes manufacturers of automobiles, aeroplanes or other products maintain displays on well-known avenues or at much-frequented resorts, which merely display the products and possibly distribute literature concerning them, but do not effect any sales or take any orders. The interested passer-by either purchases from some local sales establishment or at the selling establishment in his own country. Such an establishment should therefore be regarded as only an item of expense, and no profit should be ascribed to it. The effectiveness of

¹ *Supra*, paragraph 455.

the display will be reflected in the sales within the same country or in the other countries in which the traveller purchases the product. For all such establishments, the rule should be that in principle no profit will be ascribed to them but that their expense shall be included in the general overhead of the enterprise which is apportionable in some appropriate manner. It is argued by some administrations that the same compensation should be ascribed to such establishments as would be paid to an independent enterprise rendering similar services. Such establishments are so closely tied up with the enterprise, however, that it would be almost impossible to find an independent enterprise which would serve as a basis of comparison. No exception to the general rule should therefore be made, unless the establishment actually renders services to outsiders for which compensation is received, or renders services to the enterprise which have a determinable money value.

646. *Warehouses.* — There are other types of establishments which in themselves are not directly productive of profits to the enterprise, but which would receive compensation if they belonged to an independent enterprise — for example, warehouses. Companies frequently maintain a stock of goods in their own or a leased warehouse in order to supply promptly their dealers or distributors, or their own branches or subsidiaries within the same or neighbouring countries. These warehouses are frequently located in free ports in order to obviate payment of Customs duties, except in respect of goods imported into the country itself. The profit arises at the sales establishment in the country and may or may not be increased owing to the convenience of having a readily available supply of goods in the warehouse. It is true that, if the stock of goods were kept in a warehouse belonging to an independent enterprise, the customary warehouse charges would be paid. If such charges were paid to the warehouse in respect of goods imported into the country, the charges would only serve to reduce the profits allocable to the sales establishment or subsidiary, but would not alter the total amount of income taxable within the country which generally includes the free port in its income-tax jurisdiction. It would therefore be logical to allocate to the warehouse the customary warehousing fee only as regards goods destined for shipment to other countries.

647. The maintenance of a stock of goods in the warehouse of an independent enterprise should not in itself constitute a permanent establishment. The warehouseman receives a fee for storing them and, if they are sold within the country through dealers or distributors, the profits are taxable in their hands, and if they are sold through a permanent establishment of the enterprise, the profits will be taxable there. The fact that the enterprise might have a travelling salesman or a representative in the country who merely supervises the activities of independent dealers or distributors and directs that goods be delivered from the warehouse to them for sale to customers, should not be viewed as constituting a permanent establishment within the country. If, however, the representative of the company has an office in the country and negotiates contracts for the sale of goods which are filled out of the stock, the enterprise might be regarded as having a permanent establishment within the country, even if the contracts were confirmed at the head office in another country.¹

648. *Real Centre of Management.* — When assessing the profits attributable to a local establishment of a foreign enterprise, the great majority of countries do not allow for the allocation of any profits to the real centre of management abroad.² Likewise, countries which tax the total net profits of an enterprise because of its being organised in, or having its statutory seat in, its territory, allocate no profits to the real centre of management (viewed as a source of income) in another State.³ On the contrary, most countries allow the general overhead expense of the real

¹ See definition of what constitutes a permanent establishment, *supra*, paragraph 621.

² *Supra*, paragraphs 339 to 345.

³ *Supra*, paragraphs 587 to 593.

centre of management abroad, or interest on general indebtedness paid by the real centre of management abroad, to be apportioned to the local establishment if some definite connection can be shown with the profits locally assessed to tax.¹ Many countries which do not allocate income to the real centre of management if it is abroad, nevertheless tax the total net income² of an enterprise having its real centre of management within their territory, and this test of fiscal domicile has been adopted as the fundamental criterion in the model treaties for preventing double taxation which serve as a foundation in formulating the regime of allocation.³ It is therefore necessary to take into account the existence of this principle of taxing the total net income of the enterprise at the real centre of management on grounds of fiscal domicile, and reconcile it, in so far as possible, with that of allocating income to the real centre of management on grounds of its being a source of income. Income is attributed specifically to management in the Swiss system of apportionment by means of a *préciput*,⁴ and such recognition of "wages of management" is advocated by the International Chamber of Commerce.⁵

When Taxable Income accrues.

649. As a rule, no tax is payable except in respect of income that has been realised or derived — that is to say, the amounts owed the enterprise for goods or services have been paid in cash or have definitely accrued to it, depending on whether the books of the taxpayer are kept on a cash or accrual basis. The majority of administrations declare that under their laws a foreign enterprise is taxable in respect of profits attributable to a mine or plantation, a processing establishment or a factory within their territory, even though the goods are sold abroad. The income is deemed to be derived from economic relations with the country, or a business connection in the country, or sources in the country. Should income be taxed by reason of accrual to the local establishment regardless of whether it was eventually realised, or should the collector wait until the income has been realised abroad before assessing what he regarded as his share thereof? In other words, a profit might be considered to accrue to the local establishment as the result of its activities and the general economic circumstances of the country before its product was sold in another country. If the product were sold abroad at the anticipated profit, the accrued profit would be realised, but what if the product were sold abroad at a lower price than that anticipated or at a loss? Would the accrued profit be reduced or wiped out?

650. In *Commissioners of Taxation v. Kirk*,⁶ involving the income tax of New South Wales, Australia, a non-resident company mined and smelted ore in New South Wales, but sold all the ore at its head office in Melbourne or elsewhere, and received payment in Melbourne or London. When this case was brought to the Privy Council, their Lordships held that "there are four processes in the earning and production of this income: (i) the extraction of the ore from the soil; (ii) the conversion of the crude ore into a merchantable product, which is a manufacturing process; (iii) the sale of the merchantable product; (iv) the receipt of the moneys arising from the sale. All these processes are necessary stages which terminate in money and the income is the money less the expenses attendant on all stages". The first process seemed to their Lordships clearly within the provisions of the law concerning liability in respect of income from lands of the Crown held under

¹ *Supra*, paragraphs 346 to 373.

² *Supra*, paragraphs 567 to 593.

³ *Supra*, paragraph 611.

⁴ *Supra*, paragraph 226.

⁵ Resolution 5 of the Standing Committee on Double Taxation of the International Chamber of Commerce, Apportionment of Profits, paragraph (e), voted at meetings of May 2nd and 3rd, 1930, confirmed at meetings on November 13th and 14th, 1930; Finance Group, Paper No. 4376 and Appendix thereto. It is suggested that, when the real centre of management of an enterprise is in one country and its operations are carried out in another, a lump sum of from 5 to 20 per cent of the profits should be allocated to the centre of management.

⁶ (1900) A.C.588, *supra*, paragraphs 44 to 48.

lease, and the second or manufacturing process, if not within the meaning of "trade", is certainly included in the words "any other source whatsoever" in New South Wales, either of which entails liability. Their Lordships consequently held that, so far as relates to these two processes, the income is earned and arising and accruing in New South Wales.¹ In this case the question was whether a part of the income realised in one jurisdiction, where the product was sold, arose or accrued in another jurisdiction where the product had been mined and smelted. The Privy Council did not state that income accrued at the mine and smelter, even if no income were later realised.

651. Officials in the Netherlands East India administration, however, are of the opinion that, if a foreign corporation produces raw materials in Netherlands East India, exports them to a second country in which they are made up into finished products, possibly in competition with other materials, and sold in a third country, a taxable profit should be deemed to accrue to the establishment in Netherlands East India. This profit is delimited by the world market price for the raw material at the time of shipment, because it would be too difficult to trace the product through the processes of manufacture and sale, and if a loss were eventually suffered it might be due exclusively to faulty manufacture, improper salesmanship, or economic conditions or other circumstances outside Netherlands East India.²

652. If each establishment were a separate corporation, and the producing corporation sold the raw materials to the manufacturing establishment at the world market price, and the manufacturing establishment sold the machines to the sales corporation at an independent factory price, the selling corporation would have to bear the loss. Taxable income definitely accrued to each of the other corporations. If the third corporation could not pay for the machines, the second might claim a deduction for the bad debt, and the first might do the same if its claim against the second were uncollectable, but ordinarily each corporation would have sufficient capital funds or could otherwise secure money to meet payment.

653. On the contrary, if one branch establishment transferred goods to another at the same price as that made between the separate corporations, the profit entered in the books at the time of transfer would not under most systems be taxable if the goods were later sold at a loss. For tax purposes the accrual of income must be definitive and not merely the entering of an expected profit on the books of the enterprise. The unrealised profit can readily be eliminated from the accounts of the factory.³ Such an adjustment may be inconsistent with the general principle of treating a branch as an independent enterprise, but it is fairer thus to eliminate unrealised profit in any event as regards the joint transactions of a factory and a sales branch.

654. The question as to whether the elimination should be carried back to the country in which the raw materials were produced is more difficult to decide. The materials produced may have lost their identity through combination with other materials at the factory in the second country, and the sale in the third country may not take place until two or three years after the original materials were shipped. The simplest and perhaps fairest solution is, in principle, to allocate to the production establishment a profit delimited by the current market price on the date of shipment and allow the taxpayer to write back a loss realised elsewhere only if he can prove its direct connection with the materials shipped.

655. This question should also be considered from the viewpoint of an establishment which is engaged in other activities and receives other income from local sources than that which has just

¹ *Supra*, paragraphs 44 to 48.

² *Supra*, paragraph 44o.

³ "Taxation of Foreign and National Enterprises", Vol. V, "Allocation Accounting for the Taxable Income of Industrial Enterprises", paragraphs 62 to 66.

been described. A local establishment may derive or realise income which is attributable exclusively to its activities. Apart from receiving interest, dividends, rents and other items which may be allocated to definite sources and subject to specific schedular taxes, the local branch may derive business income from purchasing and selling within the country, or from producing or manufacturing and selling within the country. Such income is clearly from sources within the State, and under most systems would be taxed there regardless of whether the foreign enterprise realises a loss at its establishments in other countries. If the enterprise were national, however, for the purpose of a tax on total net income, such gains realised within the country might be wiped out by losses suffered elsewhere.

656. Suppose the local producing establishment sold a large part of its raw materials on the local market at local or world market prices and shipped the rest of its output to a factory of the same enterprise in a second country which manufactured machines. The machines were then sold partly by the factory in the second country and partly by a sales branch in a third country. Profits resulted from the sales in the second country, but a loss resulted from the sales in the third country. Should all or a proportionate part (depending on the circumstances) of this loss be carried in the books of the factory of the second country and carried still further back to the books of the establishment in the first country? If written back, should losses from such inter-establishment transactions be deductible from profits clearly derived from sources within the country? The deduction of losses accruing to the establishment would apparently be allowed under systems with a schedular tax on income attributable to a local establishment, and under a system taxing net income from local sources the loss would be deductible not only from business profits but also from dividends, interest and other income locally derived. Under either type of system, the local branch of the foreign enterprise is assimilated to a national enterprise of that country, in respect of its own activities; it is allowed to deduct only those losses related to its activities and not those pertaining exclusively to other parts of the foreign enterprise. By the same reasoning, if the goods were sold at a price lower than that anticipated, a proportionate part of the unrealised profit should be written off at the factory and production establishment. If, however, the prices at which goods had been transferred from one establishment to the other were independent production or factory prices, it would be simpler to regard the reduced profit as due to sales conditions and not write back the unrealised part.

657. The question of eliminating losses and unrealised profits has been considered primarily from the viewpoint of fairness to the taxpayer. There is merit in the contention that, in the light of market and economic conditions in a country the profit attributable to the activities of an establishment may be measured, though not yet realised, such profit should not be reduced or wiped out as the result of bad management or economic conditions in other countries.

658. A basis which is fair both to the State and the taxpayer could be employed which would obviate most of the difficulties previously described. It consists in regarding the factory or the sales branch as an independent enterprise and paying it the same fee or commission that would be paid to an independent enterprise for the services rendered.

659. In this way, a fair remuneration for processing and for selling is allotted for tax purposes to each of the countries concerned, and the balance of the profit, or possibly a loss, appears in the books of the real centre of management, which we will assume to be at the plantation, mine or other principal establishment. If the whole series of transactions results in a loss, the country of the real centre of management should not object because the deductions claimed for compensation, cost of transport, etc., would have been incurred if the processing and selling had been done by an independent enterprise. Assuming that the processing establishment and the sales establishment are branches of the same corporation which produced the raw materials in question, it is clearly possible to allot to the processing establishment and the sales establishment the same remuneration

that each would have received if it had been an independent enterprise. If the real centre of management were in a country other than that of the mine or plantation, it should be possible to compute an appropriate fee on the basis of the amount produced (although the market value of the raw materials at time of shipment might be a more accurate measure of the worth of the establishment to the enterprise).

660. The application of this method is not necessarily limited to raw materials, but it can be applied as well in the case of machines, textiles and other products. The country of processing or sale may find it advantageous, because it receives, as a basis for its tax, remuneration for the services rendered regardless of whether the enterprise as a whole realises a loss. On the contrary, either country may consider its tax basis as being arbitrarily restricted, especially if the enterprise realises a large profit, which, if apportioned, would throw to each country a larger tax basis than that of the fee or commission charged. This objection may be outweighed by the practical advantage of not having to ascertain what part of the net income from joint activities is attributable to the local establishment, as well as that of collecting a tax on the commission (percentage of gross receipts) or fee even when the enterprise itself realises no net income. The enterprise has the advantage of knowing definitely that it will be taxed on the same amount it would pay to an independent enterprise for rendering it the same services, and of not having to submit the head-office accounts in order to effect an allocation of net income.

Losses from selling below Cost — Dumping.

661. It is argued by some administrations that the selling of goods by an establishment within a country, even at a loss, may permit the corporation to realise a profit because of enabling it to spread its overhead over a larger number of units produced and thereby decrease the cost of production per unit and widen the margin of profit in the home country or in other countries where the goods are sold at a price higher than the unit cost. They conclude that a proportionate part of this profit realised elsewhere should therefore be allocated to the local sales establishment. It is presupposed here that the enterprise is honestly endeavouring to maintain or increase its plant capacity and is not intending to dump goods in a market in order to reduce its surplus stock or to undersell in order to take the market away from a competitor by unfair methods. Provisions to prevent or penalise such methods are generally found in Customs laws and laws against unfair competition, and such methods should be dealt with under such legislation rather than by means of arbitrary assessment under the income-tax law. In times of depression, a factory may endeavour to keep up its volume of production in order to continue to employ its workers, and may therefore sell in any market at whatever price it may get for its goods. If the foreign countries in which sales establishments or subsidiaries are located have gone off the gold standard, while its goods are produced in a country in which values in gold still obtain, it may well be necessary to sell at or even below the cost of production. It is to be expected, however, that such a situation is temporary and that either economic changes will gradually take place in the relative situations of the country of sale and the country of production, or else reductions will be effected in the cost of production which will enable the enterprise to sell at a profit. A further feature of depreciated currencies is that the foreign manufacturer may consider it necessary to sell his products in a country of depreciated currency at what would be a fair price in the currency of such country at normal exchange rates. This may be substantially less than the then existing exchange value of the price for which he is selling in other countries. This is not a real "dumping" procedure, but is simply the endeavour to maintain a market for his products and what he believes will in the long run prove to be a fair price in the local currency of that country. It is also to be remembered that the introduction of goods into a new market is apt to be more difficult and expensive than their sale in an established market. This may be met by the additional expenses for selling, actual or relative, or by price reductions for the goods sold. In either case it may represent simply the

willingness of the producer to take a loss, perhaps for several years, in the hope for profits in the future. If the enterprise continues to realise a loss in a given country, it will, as a rule, sooner or later terminate its operations in the country of sale. The experience of many corporations in the past few years evinces the truth of this statement. Consequently, it should not be admitted as a rule that a country should attempt to reach out and assess a saving in the cost of production which results from sales effected in its territory.

Apportionment of Net Profit or Loss.

662. After the gross income, and related deductions, have been allocated to each country, the next question is whether the enterprise will have to pay tax on a net profit realised by the establishment in one country, although the enterprise as a whole has suffered a net loss. The Spanish administration declares that it follows the principle of capacity to pay and that, if the enterprise as a whole eventually realises a loss, it should not be required to pay any tax in Spain except for the minimum tax imposed on the basis of capital. Even if a profit were clearly attributable to the establishments in Spain, it would be wiped out by the loss realised in other countries.¹

663. On the contrary, the great majority of the administrations maintain that the local establishment should be assessed separately, whether it realises a profit or loss, without regard to the profit or loss of the enterprise as a whole.²

Basic Methods of Allocation.

664. Having examined the fundamental principles of allocation that may be disengaged from the law and practice of the majority of countries, let us now consider their basic methods of determining the taxable income of a foreign enterprise. The two underlying theories of taxing foreign enterprises with local establishments are :

1. That the local establishments should be taxed on the basis of separate accounts and treated in so far as possible as if they were independent enterprises.

2. That the enterprise is an organic unity and consequently the tax should be assessed on that part of the enterprise's total net income (computed in accordance with the law of the taxing country) which corresponds to the relative economic importance of the local establishment. This method is known as unlimited fractional apportionment. The advocates of this method contend that, in a unitary business which, for example, produces raw materials, manufactures them into finished products and then sells them, no profit is realised by the enterprise as a whole until the goods have been sold. They contend furthermore that it is impossible to determine accurately what part of the profit is attributable to each function or establishment of the business and consequently the profit can only be apportioned on some empirical basis — for example, an arbitrary apportionment formula. Moreover, they say it is the only way of applying the fundamental principle of taxing the enterprise in accordance with its capacity to pay.

665. Whether a given administration employs the separate accounting method or the fractional apportionment method in assessing a foreign enterprise, the object is the same — namely, to determine the income taxable in its jurisdiction.

666. When the problem of taxing a foreign enterprise is viewed from the general principle that a State has jurisdiction only over persons within, property situated within, or transactions effected within its territory, it is obvious that, if the taxpayer resides in a foreign country, the

¹ *Supra*, paragraph 380.

² *Supra*, paragraphs 374 to 382.

State's jurisdiction over its income should be restricted to income from property or other source within its territory. The principle of permitting only the country of fiscal domicile to tax the total net income of the taxpayer is so generally accepted that it would appear inconsistent to incorporate in the regime a provision permitting any country in which the enterprise has a branch establishment to take jurisdiction over the total net income in order to determine what part thereof might be attributable to the local establishment.

667. Various Governments which apply the method of fractional apportionment maintain that the total net income shall be computed in accordance with their own legislation, even though only a very small part thereof may be attributed to the local branch.¹ This involves not only determining gross income from sources in one or more foreign countries, but also allowances for business expenses, bad debts, depreciation, losses and other allowable deductions. Assuming that the administration in question were endeavouring to make as accurate a computation of income as possible, how would it verify the claims for deductions in respect of these items which pertain to establishments situated in other countries perhaps beyond the seas or on the other side of the world? Its determination under its own law of income clearly arising in other countries would usually be different from the amount determined under such other countries' own laws. Perhaps many establishments of a large foreign enterprise have no direct or even an indirect relationship to the establishment within the taxing State. How then can its administration demand information concerning income and related deductions derived from such sources which are obviously beyond its jurisdiction?²

668. It is true that the Netherlands and its colonial possession, Netherlands East India, have entered into an agreement³ whereby the colonial administration may send representatives to Amsterdam, or other cities in the home country, to examine, with the permission of the taxpayer, the head-office books in order to facilitate the allocation of income as between the head office and the establishments in Java and Sumatra. It is doubtful, however, if the arrangement is susceptible of general adoption as between foreign countries which have no such "family relationship". Obviously, if the inspectors of one country were permitted quite generally to go through the accounts of enterprises in the second country which had branches in the first, the arrangement would tend to contribute to animosity rather than good will between countries. Moreover, the expense of maintaining such inspectors and of recomputing net income according to the tax laws of each foreign country in which there was a branch would increase the burdens on international business rather than conduce to their alleviation.

669. The requirements under fiscal or commercial law for maintaining accounts, the differences in accounting methods, in language, in currency and the incidental problems of evaluation and exchange all tend to support the method of separate accounting.⁴ Moreover, the Customs requirements of the different countries tend to force a segregation of the business profits realised therein. The economic factors such as *per capita* purchasing power, the tastes of the population, the costs of doing business — for example, those of transportation, compensation for employees, labour insurance and taxes — result in a profit-making capacity (*rentabilité* or *Ertragsfähigkeit*) which varies from country to country and which can be accurately reflected only in separate accounts kept as nearly as possible on the same basis as those of an independent enterprise in each country in which the enterprise has establishments or subsidiaries. It is needless to point out that the establishments or subsidiaries in one country may realise profits, in some cases

¹ For example, *supra*, paragraphs 238 and 249.

² Cf. *Whitney v. Inland Revenue Commissioners*, 10 T. C. 88 at page 102.

³ *Supra*, paragraph 237.

⁴ *Supra*, paragraphs 293 to 310; "Taxation of Foreign and National Enterprises", Vol. V, paragraphs 2 *et seq.*

large, in others small, whereas the establishments or subsidiaries in other countries may realise losses. This may be due to changing market conditions or fluctuations in the currency, and is especially true if one or more of the countries goes off the gold standard. The apportionment of the total net income of an enterprise carrying on world-wide operations means that its profits and losses will be pooled and then distributed fairly evenly, by the use of arbitrary factors, to the various countries in which it operates, and not to the actual sources of the income. Will countries in which profits have clearly accrued agree to giving up a part or all of such profits as a result of an apportionment of the total net income or loss of the enterprise? The great majority of administrations have definitely indicated that they would not.¹

670. One very practical difficulty in the way of applying the method of fractional apportionment as between several separate countries perhaps in different parts of the world would be that of securing agreement as to the total net income and the basis for apportionment. Even between the States of the United States but little uniformity in these fundamental questions exists.² The application of the Swiss method³ on an international scale would require, first, an agreement between the interested countries as to the total net income of the enterprise, and, secondly, agreement as to the productive factors in relation to which the total net income would be distributed. If the Spanish system of apportionment⁴ in the ratio of economic importance were employed, it would require, first, an agreement as to total net income, and, secondly, agreement as to the economic importance of the establishment in each country, a question on which opinions would be very likely to disagree. The difficulties that would be encountered in the general application of such methods appear almost insuperable. It is therefore desirable that the regime to prevent double taxation should not depart from the fundamental principle that a State's jurisdiction is limited to only that part of the business income of a foreign enterprise which is directly attributable to a permanent establishment within its territory and recognise, therefore, that such income should be determined on the basis of a separate accounting.

671. *Separate Accounting.* — The adoption of separate accounting as the primary method of allocating income to the various countries in which an enterprise has permanent establishments is preferred by the great majority of Governments,⁵ and business enterprises represented in the International Chamber of Commerce,⁶ as well as by other authoritative groups.⁷ Broadly speaking, the objectives of the method of separate accounting are as follows :

(a) To maintain accounts for the establishment (or establishments considered as an accounting unit) in each jurisdiction which reflect the items of taxable income and related expense directly allocable thereto, and provide the essential data for apportioning items of joint income and expenses (*e.g.*, pertaining to the joint activities of two establishments) which cannot be directly allocated ;

(b) To preclude taxing the establishment in so far as possible on unrealised profits ;

(c) To fulfil these objectives by the use of data pertaining directly to the establishment which can be verified in the country of the branch establishment with the minimum use of data pertaining to the enterprise as a whole.

¹ *Supra*, paragraphs 374 to 382.

² *Supra*, paragraphs 67 to 83.

³ *Supra*, paragraphs 221 to 231.

⁴ *Supra*, paragraphs 184 to 210.

⁵ *Supra*, paragraphs 292 *et seq.*

⁶ International Chamber of Commerce, Standing Committee on Double Taxation, November 13th and 14th, 1930, R. solution No. 5, Appendi . to Paper No. 4376 and the Resolution of June 30th, 1933, Vienna Congress.

⁷ The National Tax Association of the United States, report of the Committee on Uniformity and Reciprocity in State Tax Legislation, Proceedings of the Twenty-fourth National Conference, October 12th to 16th, 1931, pages 302 and 303 ; American Institute of Accountants, report of Special Committee on International Double Taxation, *Bulletin of American Institute of Accountants*, June 15th, 1931, pages 5 to 10.

672. It is considered undesirable to endeavour to prescribe detailed rules of separate accounting, because enterprises are so varied in their nature and each enterprise is likely to change so frequently its methods of operation in order to meet changing conditions that it would be unwise, if not impossible, to lace them all in the same accounting corset. Moreover, accounting for the internal purposes of a business often differs from that for tax purposes because of the provisions in fiscal laws regarding the items of income to be taxed and allowable deductions. Nevertheless, the accounts must meet the requirements of tax laws and be adequate for the computation of taxable income. The accounts maintained for each establishment should be kept there if possible so as to be readily accessible for inspection. If the establishment is relatively unimportant, such as a small sales office, it might be too expensive to maintain a trained accountant there and a complete set of accounts pertaining to that establishment. It should be a minimum requirement for income-tax purposes to have books kept at such an establishment showing its receipts and expenditures. Other information regarding income and expense relating to its joint activities with other establishments could be supplied when necessary to support the declaration of income. A detailed discussion of various methods of accounting which may be used to reflect separately the income of a branch of an industrial or mercantile enterprise is to be found in "Allocation Accounting for the Taxable Income of Industrial Enterprises", by Professor Ralph C. Jones.¹ The country of fiscal domicile which claims jurisdiction over the entire income of the enterprise should, for purposes of allocation, be regarded as the residuary claimant to all income which is not allocated to a branch establishment or subsidiary company abroad. To facilitate the verification of the accounts of the branch establishments, the head office should so order its accounts that the taxable profit or loss resulting from transactions with each of the establishments is separately reflected.

673. *Empirical Methods.* — Empirical or estimative assessments² are resorted to by most fiscal administrations when accounts pertaining to the local establishment are insufficient, or the business is of such a nature that appropriate accounting methods to reflect its taxable income cannot readily be devised. Sometimes when a branch is newly opened, an agreement will be made with the fiscal authorities to pay annually a lump sum or tax on a percentage of its turnover, until the business is sufficiently launched to permit of a more accurate determination of its income. Obviously, empirical methods are inconsistent with the fundamental principles of income taxation; but, if the taxpayer cannot maintain a separate accounting adequate for tax purposes, it may suffer estimative assessments, or even penalties. The resulting double taxation might be regarded as an additional self-inflicted penalty if fraud is involved; but, if there is no fraud but merely negligence or ignorance on the part of the taxpayer, he should be permitted to adjust his assessment with the interested administrations. Although the percentage of turnover method³ is the empirical method most frequently used, it would be unwise to permit only its use, as the circumstances of a given case might require recourse to other methods. In using such methods, the tax administration should be required to limit its assessment to what would be earned by an independent enterprise engaged in similar activities and under similar circumstances.

674. *Fractional Apportionment.* — The great majority of administrations and business men are in accord that the method of fractional apportionment should not be applied as a rule in assessing the local branches of enterprises engaged in international business.⁴ Nevertheless, this method is now employed by certain administrations as a normal procedure and by others when the method of separate accounting fails. For the reasons previously given, however, separate

¹ "Taxation of Foreign and National Enterprises", Vol. V.

² *Supra*, paragraphs 155 to 172.

³ *Supra*, paragraphs 160 to 172.

⁴ *Supra*, paragraphs 293 to 331; also footnote to paragraph 671.

accounting should be adopted as the primary method for all types of enterprises and recourse to fractional apportionment should be admitted only by way of exception when separate accounting is impossible or impracticable. The regime of allocation must be sufficiently elastic to apply to all types of enterprises and a departure from the rule of separate accounting should be admitted if the taxpayer and the interested tax official agree that it is more equitable to apportion joint income of two or more establishments, or the total income of the enterprise, in the ratio of appropriate factors. It rarely occurs, however, that an establishment in one country receives goods from or transfers goods to other establishments or subsidiary companies or an enterprise without it being possible to determine its profits on the basis of its separate accounts and with recourse, if necessary, to some appropriate method of apportioning joint profits. In other words, the most simple and practical way of assessing the local establishment is to focus the fiscal eye on its accounts and activities in order to determine its income, rather than to start by searching through the forest of figures pertaining to the entire organisation in order to recapture items of income that may have escaped and write them back into the accounts of the local establishment, or corral all the profits and apportion a part thereof to the local establishment in accordance with some arbitrary factors.

675. *Limitation on Total Assessments.* — It must always be kept in mind that the administrations of the two or more countries in which there are establishments participating in the production of income should be in agreement, first as regards the method of allocation or apportionment, and second, as regards the manner of applying it; otherwise, assessments may overlap and double taxation will result. To prevent disputes, a treaty concerning allocation should provide definite and precise rules for application in the case of the predominant types of establishments.

Allocation Criteria.

676. In devising an allocation procedure which will reflect the income of an establishment in its separate accounts, it is essential to select methods which conform to the principles of allocation previously stated. While, on the one hand, income should be thrown to the real centre of management, not only because it is the fiscal domicile and centre of direction and risks of the enterprise, on the other hand, income must be divided between the establishments engaging in the various stages of production and sale and those which render various services to the enterprise susceptible of evaluation in terms of money. There is apparently no theoretically perfect rule for determining exactly how much of the income is attributable to each establishment any more than there is an accurate way for apportioning the compensation of an individual workman to his hands and his feet, and to his brain which has coordinated all his efforts. Income is sometimes classified, for tax purposes, as income from capital, income from work, and income from work and capital combined, the profits of an industrial and commercial enterprise being included in the last-mentioned category. It is obvious that the proportion of work to capital varies from business to business and that, in the alchemy of a successful business, the intangible, immeasurable element of brainwork is a very important factor, if not the most vital factor. This is impossible to measure accurately, and the only formal recognition is in the *préciput* ranging from 10 to 25 per cent of the total net profit which is allotted by the Swiss cantonal authorities to the seat of management.¹ The element of labour itself in a given country is susceptible of measurement in terms of number of employees, salaries paid, or aggregate working hours; and the element of capital can be evaluated in terms of tangible and intangible assets. These concrete factors can be employed in measuring roughly the benefits which the State accords to the local establishment in the form of police and fire protection, education and the like, but even combined they form an inadequate measure of the income attributable to the establishment. One must acknowledge that the price received for goods

¹ *Supra*, paragraphs 226 to 229.

or services depends in general on market conditions in the place of sale, rather than upon any evaluation that may be placed upon assets or labour. The profits of a business depend upon commercial conditions and vary in form with the methods of operation customary in the trade or practice. It is these methods which are advocated as criteria for measuring the profits.

677. *Remuneration for Services Criterion.* — The fairest and most generally practical criterion is that of what would be earned within the country by an independent enterprise engaged in similar activities under similar conditions, such conditions including capital invested, volume of business or services rendered, costs and risks. This test is readily applicable in the usual case where an enterprise has its principal establishment in one country and secondary establishment in others. For example, the secondary establishment may purchase goods and process them for shipment, possibly to a refinery or other processing establishment or possibly to the factory at the principal establishment. The manufactured goods are then shipped possibly to an assembly plant in another country, or possibly direct to a sales establishment. If the principal establishment were at a plantation or mine, it might ship the raw materials to its own refinery in a neighbouring State before sending them on to the sales office. In such cases the real centre of management is probably at the principal establishment. The control and management, financial and technical, are centred there. At the meetings of the directors the decisions are taken which make or break the enterprise. There the risks are centred. The profit or loss results from all the activities of the enterprise taken together, but how can the part attributable to the establishment in each country be most readily measured? If we recognise the fact that the real centre of management, especially if it is situated at the principal productive establishment, is the most vital part of the enterprise, the most practical approach to the problem is to give it the residuum of profit or loss after allocating to each outlying secondary establishment compensation for the services it has rendered to the enterprise in accordance with what would be paid to an independent enterprise rendering such services.

678. *Sale between Independents Criterion.* — There is another approach — namely, that of regarding each establishment as an independent enterprise which purchases and sells the product for its own account. Whereas the former method presupposes a consignment of the goods from one establishment to the other by the real centre of management which retains the title to the goods and bears all the risks of ownership, the latter method involves a fictional transfer of title with all the related risks of ownership. Obviously there must be allotted to the branch capital it would need to carry on its operations or else the gross profit must be reduced by an amount equivalent to interest on borrowed funds used in its operations and to losses or risks of losses that would be carried by a similar independent enterprise.

679. Unless an establishment is virtually autonomous and has but few relations with other establishments, it is obviously difficult to determine the amount of capital adequate for its purposes. If a definite amount is allotted to it by resolution of the board of directors, how is the advance of additional funds to be treated? Can interest be charged by the real centre of management and claimed as a deduction by the branch? Under existing law, such a deduction would probably not be granted especially if the advance were out of the enterprises own capital, because of the principle that a taxpayer cannot loan money to itself, and also that it cannot deduct interest on its own capital. Moreover, unless the real centre of management borrows funds specifically for the branch, they are likely to become mingled with its general operating funds and it would be impossible to determine exactly how much of the advance was out of capital and how much was out of borrowed funds. It could be presumed that the proportion of borrowed funds to capital in the amount advanced to the branch was the same as the proportion of borrowed funds to capital in the entire enterprise, and an allowance could be made for the same proportion of the interest paid to the outside lender as the borrowed funds included in the advance to the branch bear to the total borrowed funds. If, however, the establishment were essentially dependent on other establishments because of the flow of goods

to and from it, it would become almost impossible to ascertain how much was actually branch capital and how much was advances to the branch. The difficulties inherent in allotting a capital to a branch which is not virtually a separate and autonomous unit are so great that it should be avoided wherever possible. Moreover, one of the great advantages of doing business through branches should be the freedom to transfer funds to the branch or withdraw funds from it as the current of its business requires.

680. *Proposed Precept for selecting Method.* — In order to avoid fictions as much as possible, it is recommended that, as a general rule, a method of allocation should be chosen which would require the allotment of only current operating funds to a branch, and would treat a transfer of goods as a consignment rather than a sale. In other words, the preferable method is allocating income on the basis of compensation for services rendered. Income should not be allocated by presuming a sale unless the branch is sufficiently autonomous to justify the allotment of an adequate capital.

681. *Proposed Rule for Deduction of Interest.* — As regards deductible interest, the simplest rule would be that interest on advances should not be deductible in determining the taxable net income of the branch, unless the money is borrowed directly from outsiders by the branch and for its use and corresponds in amount with what would reasonably be required by an independent enterprise under similar circumstances.

682. *Proposed Rule for allocating Overhead.* — To avoid further complications, methods of allocation should be chosen which do not entail apportionment of general overhead. If the method involves the use of prices at which goods are sold to customers, the item of overhead should be included therein and no additional apportionment should be necessary. Otherwise general overhead should be apportioned in the ratio of the gross profits allocated to the several establishments, unless some other method of apportionment may be applied on grounds of being more equitable.

683. *Independent Commission or Fee Basis.* — The simplest method of marketing goods is to consign them to a commission agent, who receives the commission customary in the trade where the goods are sold. The commission represents the value of his services to the consignor. If shipments were made by a foreign enterprise to a local establishment on a consignment basis, to be sold or processed, the determination of the commission or other compensation to the local establishment could be verified by a comparison with what a local independent enterprise would receive for similar services under similar conditions. In many markets there is a customary commission for each particular class of raw materials or finished products that are susceptible of sale on this basis. The fee of course varies in amount with the costs and risks undertaken by the local commission agent. The local agent who receives and warehouses the goods, pending their sale on a local exchange or in the local market, is obviously entitled to more compensation than one who merely acts as a broker in obtaining customers to whom the goods are shipped direct. If the local agent acts as a *del credere* agent, guaranteeing the solvency of the buyer, it is customary for him to receive a higher commission because of the risk he thereby assumes. If the local agent received manufactured goods on a consignment basis and undertook to carry advertising cost in the local market, he would obviously be entitled to a higher rate than one who did not bear such costs. In other words, the only theoretically sound way of evaluating the commission that the local branch should receive for its services is by considering what an independent agent would accept for similar services with a view to making a profit on a normal or reasonable volume of business commensurate with the capital invested, the operating costs, and the degree of risk involved; and also taking into account what other agents would require for such services. Obviously, if a consignment is made to a branch establishment, the enterprise carries the risk and finances the sale and, strictly speaking, the branch does little more than make the effort necessary

to sell the goods. The commission even for an independent commission agent would therefore generally be limited to compensation for services rendered and possibly a return on the small amount of capital involved. This commission, consisting of a percentage of sales receipts or turnover, represents gross profit accruing to a sales establishment when a sale takes place. The net profit of the sales establishment is computed by deducting from the gross amount thus allocated to the sales establishment, its actual expenses incurred in handling the goods after taking delivery thereof.

684. The same general reasoning applies in respect of establishments processing certain raw materials. For example, it is customary for a mine to ship copper or other minerals to be refined at an independent plant, which charges so much per pound or other unit of measure. The price largely depends upon the volume of the products to be refined. Obviously, the refinery must charge enough to realise a profit over all costs, but this price is limited by the price for which competitors will do the same work. The same is true of plants which refine or process sugar, flour, rice and other raw materials. In any event, an average of these competitive prices could be computed which would serve as an appropriate comparative compensation for the enterprise to allot to its own smelting or other processing establishment. ¹

685. *Independent Dealer Price Basis.* — It is in connection with the manufacture and sale of trade-marked or branded articles or specialties that administrations may object to the use of the independent commission basis. It is argued in the first place that it would be impossible to determine by comparison with similar enterprises an appropriate commission or other compensation to a sales office, for the simple reason that there are no independent enterprises selling the same product. Furthermore, it is contended that the profit is attributable to sales effort rather than to manufacture. This is a moot question which cannot be answered categorically for each type of article concerned. The relative importance of skill and effort in manufacturing and in selling is a bone of contention among the officers of almost every enterprise. The sales staff insists that, without their skill and persistence in getting customers, nothing would be sold, and consequently the factory would have no reason to exist. On the other hand, the factory staff replies that, if it were not for their ability to produce a better and cheaper article than that of competitors, or if there is no immediate competing article, an article sufficiently inexpensive and attractive to appeal to the customer in the first instance, and good enough to induce the customer to buy again and recommend the article to others, the efforts of the salesmen would be in vain. To find a practical basis of allocation and apportionment, it is necessary to consider factors more ponderable than these. It is not improbable that the company will market its product to a large extent both in its own country and abroad through independent dealers, the price at which they purchase from the enterprise being determined without consideration of tax liability and in accordance with what each must receive to cover capital invested, expenses and incidental risks, and allowing a fair margin of profit on a reasonable volume of business. Such an independent dealer's price should be acceptable to the authorities in the country of the sales branch as a basis for splitting the profit between the manufacturing plant and that branch, subject, however, to the taxpayer showing why there should be any deviations from this price because of conditions peculiar to the country of sale. The same observations apply if the branch acts as a wholesale dealer.

686. In order to verify the profits arising to the sales branch, the tax authorities may make a comparison with similar local enterprises. It may be argued that it is unfair to compare the local branch of a foreign enterprise with a national enterprise because the local branch is selling

¹ See also "Taxation of Foreign and National Enterprises", Vol. V, paragraphs 127 to 131.

goods which have been produced in another country under different conditions and therefore at a different cost, and consequently have been transferred to the local branch at a price which corresponds to an independent dealer price to dealers in the country of production which may be greater or less than the independent dealer price for such goods in the country of sale. If the independent dealer price of the country of production is greater than that in the country of sale, and is increased by insurance, freight and other transportation costs and Customs duties, obviously the margin of sales profit will be lower because the sale price will be determined by competitive conditions in the country of sale. The foreign enterprise may have to expend much more money in advertising and sales effort than the national enterprise, which will further reduce the net profit from local sales. If the tax authorities assume that the local sales branch realises the same profit as a national enterprise, it would impose a greater burden upon the local branch than that imposed on similar enterprises.

687. On the other hand, if the independent dealer price in the country of production, plus insurance, freight and other transportation costs and Customs duties, were lower than the independent dealer price in the country of sale, the foreign enterprise would be in a position to undersell local competitors and possibly still realise a net profit greater than that realised by its competitors, although this is seldom likely under existing tariff laws. If it were taxed on the basis of a comparison with the profits realised by the local competitors, its assessed profit might therefore be less than its actual profit and the foreign enterprise would enjoy an advantage over the national taxpayers. Cases such as this evince the wisdom of endeavouring to make as accurate a determination of the income as possible in order that an appropriate burden may be imposed on the local branch. It is nevertheless obvious that, in general, the local administration will have to determine income in the light of the economic and competitive conditions within its own territory, as it is not within its reach to ascertain definitely the economic and competitive conditions in all countries from which goods are shipped to local sales branches.

688. A more accurate comparison would require the tax official to examine the conditions under which the price to dealers is determined — that is to say, whether the dealer pays cash or receives a long term of credit ; whether the dealer bears the cost of advertising ; whether the dealer agrees to service the machine, etc. The price or discount allowed the dealer inevitably must be greater in proportion to the additional marketing and incidental costs which he undertakes to bear. On the other hand, if most of the marketing costs are borne by the manufacturer, the dealer's discount or mark-up is reduced to compensation for his selling effort, and a return on whatever capital he has invested in his establishment.

689. The strict application of the independent dealer price method presupposes an accounting that would reflect the net income which would be derived if an independent dealer, with an adequate capital, purchased the goods for resale at his own risk. In other words, the application of this method to a mere branch of a foreign enterprise necessitates the fictional transmission of a part of the direction, capital and risks that would belong to the branch if it were an independent enterprise. If the transfer price is the price at which goods are sold to independent dealers, it should include a proportionate part of general overhead expense and no additional apportionment thereof should ordinarily be allowed. From the gross profit, represented by the difference between the sale price received from customers and the fictional price it paid the factory, there must be deducted, in order to compute the theoretically correct net profit, not only the cost of the sales establishment, but the other expenses and losses which would have been incurred if the branch had been an independent dealer, including all transportation costs to the branch and Customs duties, interest on borrowed funds tied up in the merchandise pending sale by the branch, losses resulting from having to sell the goods at a reduced price, at a loss, or from not being able to sell them at all. In theory, all these expenses and losses would be borne by the branch, and some appropriate method

of computing them would have to be devised. In fact, they have been borne by the whole enterprise at its real centre of management. Some of the losses might be reduced or prevented by shipping goods which cannot be sold in one country to a branch in another where the market is good, or it may remodel or scrap such goods. The decisions for such action are made by the real centre of management; the risks are borne by it. Any attempt to apportion risks in terms of deductible expenses can at best be empirical. It is clear that it is compensation for these risks incident to taking title to the goods that comprise the greater part of the discount or margin of gross profit that would be required by an independent dealer, and if it were acknowledged that in the case of a branch such risks were borne by the real centre of management, the profit allocated to the branch would be reduced to an appropriate remuneration for services rendered, in other words, an amount equivalent to that described above as a commission or fee.¹

690. *Comparison of Commission and Dealer Price.* — From the viewpoint of the selling establishment, it has been shown that the commission basis is simpler than the dealer's price basis, because a definite amount is paid for services rendered at the rate customary in the trade and easily verified, and there is no problem of eliminating unrealised profits from inventories of goods shipped to the branch. On the contrary, the verification of the dealer's price involves checking prices made by the factory to independent dealers in other countries and allowing for deviations due to conditions in the country of the branch. It may even entail checking of factory costs in case the fairness of the dealer's price is questioned. From the viewpoint of the factory, the commission basis is simpler because it involves no inventory adjustments for unrealised profits.²

691. The commission represents an apportionment of joint profit between selling and manufacturing, but it is locally determinable. The verification of the dealer's price involves checking of the factors which determined the invoice price, and the information pertaining to all these factors is at the factory office or the real centre of management in another country. If the tax authorities lower the dealer's price to increase the margin of profit without there being a compensating adjustment in the price entered in the factory accounts, double taxation results. It is therefore necessary for the administrations of the countries involved to accept the independent factory price if the taxpayer proves it to be fair and adequate regardless of considerations of tax or Customs liability.

692. *Independent Factory Price or Fee.* — If the factory is the principal establishment and at the real centre of management of the enterprise and its products are sold through branches in other countries on either the commission basis or the independent dealer price basis, the balance of the gross profit after deduction of the commission or dealer's profit attributable to the sales branch is of course allocable to the factory. In other words, the profit is divided between the selling branch and the manufacturing plant in accordance with the commercial worth of the sales establishment to the enterprise as measured by operating methods normally employed for the particular class of business. If the income allocable to the sales establishment is thus determined, the independent commission or dealer's price should be acceptable to the administration of the country in which the factory is situated. Commission rates are often standardised, and the dealer's price can be compared with the factory price charged to outsiders for similar goods under similar conditions.

693. In rare cases, an enterprise with its real centre of management in one country may have a factory in a neighbouring country. If the factory is of secondary importance and merely manufactures or processes goods which are sold in the first country, the amount of income

¹ See also "Taxation of Foreign and National Enterprises", Vol. V, paragraphs 57 to 73.

² See also *ibid.*, paragraphs 62 to 66.

attributable to the factory could most readily be determined by making a comparison with the price that would be paid to a similar independent enterprise for such services, or, if the factory did similar work for outsiders, it could charge the enterprise the same amount. If, however, the factory in the second country were a fairly self-contained unit which manufactured goods for sale in that country and in third countries, the materials could be consigned to that factory and later to the sales establishment, allowing an appropriate remuneration to each, the balance of the profit accruing to the real centre of management ; or else the allocation between the factory and the sales branch could be effected on the independent commission or dealer price basis, and the real centre of management could be allowed a certain sum for its activities, either in the form of a charge for services to the factory or as a *préciput*.¹

694. *Constructing an Independent Factory Price.* — If the enterprise does not market any of its products so as to establish an independent factory price, it may endeavour to construct one, considering the eventual sales price, the gross profit that would have to be allowed to the dealer to cover his investment, expenses and risks, and whether this price would allow to the factory a fair profit over its investment, expenses and risks. In other words, the taxpayer imagines the terms that would be agreed to between itself and an independent enterprise dealing at arm's length. The practicability of this method depends considerably upon the situation in the given line of business — in some lines dealer's discounts or mark-ups are fairly well standardised.

695. If there is no customary dealer's allowance, the manufacturer may approach the problem from his own standpoint. To compute the price at which he is willing to sell to independent dealers, he will normally include the cost of materials, the cost of converting them into finished products, a part of the general overhead, and a rate on capital invested. If advertising expense is borne by the manufacturer, the factory price will be commensurately higher ; if borne by the dealer, proportionately lower. The margin of profit to the manufacturer, however, will depend largely on the price at which he can sell his product in the different markets and the margin of profit that he will have to allow to the dealer. The same allowances for risks presumptively borne by the dealer should be made as in the case of an independent dealer's price,² and the application of this method involves so many presumptions that it is hardly practicable.

696. *Apportionment Formulae.* — The manufacturer makes his calculation of the independent factory price in anticipation of realising a profit. Once the profit has been realised, it may or may not be as large as that anticipated. It is not easy for the tax official in retrospect to compute what part thereof is allocable to the sales establishment within his jurisdiction and the factory in the other country because of the difficulties incident to verifying data pertaining to the manufacturing which may be expressed in a different language and currency, and in any event must be considered in the light of conditions in the country of manufacture. Nevertheless, it must be assumed that he will be willing to listen to the taxpayer's presentation of his own case and accept the allocation if it can be readily verified. He can easily check the expenses of the local establishment, and, if certificates or affidavits as to costs at the factory can be obtained from well-known firms of accountants, he should be able to test the reasonableness of the allocation made by the taxpayer itself, or effect an apportionment of net profit which will give results fairly equivalent to allocation on the basis of an independent commission or dealer's price.

697. The methods for apportioning joint net profit are numberless. Ordinarily, the merchandise is transferred from the factory to the sales branch at cost. The amount of sales receipts is definite for both States concerned, but to compute the apportionable net income, each

¹ See also "Taxation of Foreign and National Enterprises," Vol. V., paragraphs 108 to 116.

² See also *ibid.*, paragraphs 74 to 96.

State generally grants only the deductions for expenses, bad debts, depreciation, etc., allowed under its own law. Consequently, each State claims a share of a different amount of net income. The tendency on the part of some administrations is to elect factors which throw to the local establishment the greater part, if not all, of the profit.¹ Two instances in which a basis for apportionment have been agreed upon as between interested jurisdictions are found in the Austro-Czechoslovak and Austro-Hungarian Treaties ;² subject to the right of each country to determine the net joint income in accordance with its own law, the net joint income apportioned in the ratio of two-thirds to manufacture and one-third to sale. It is interesting to note that other formulæ using different factors³ (e.g., Massachusetts formula) are said by business men to give a fairly equivalent result. The principal criticisms of the system are that, first, it is arbitrary and does not necessarily conform to realities ; and, second, that because of the different provisions regarding taxable income and allowable deductions under the law of each country, the taxpayer will have to recompute his entire net income for each country in which he has a permanent establishment, merely in order that a part of such income may be apportioned to an establishment. Aside from the duplication of efforts, this system may lead to endless difficulties, especially in regard to the verification of items outside the jurisdiction of the taxing State.

698. The reasons for arguing that this formula is arbitrary are fairly obvious. In the first place, owing to faulty operating methods or to economic circumstances, a loss might actually be realised in one country, yet it would automatically receive a part of the profit realised in the other country ; secondly, the ratio of two-thirds to one-third does not necessarily reflect the relative importance of manufacturing and selling in every type of industrial and mercantile enterprise. For example, the cost of producing many types of patent medicines, toilet lotions, cosmetics and other articles is very low, whereas large amounts are spent in advertising and sales efforts to induce the public to buy. At the other extreme, the sales price of automobiles, typewriters and certain other articles is limited by the necessity of underselling competitors, and the management of the enterprise first determines the sales price and probable advertising and other sales cost, including compensation to dealers, and then figures how to turn out a more attractive product than that of its competitors at a lower cost of production. The profit depends largely upon the saving in manufacturing cost, without reducing in any way the efficiency or quality of the product, but preferably increasing them. In such large industrial enterprises the bulk of the expenditure is at the factory in maintaining and improving the plant and machinery, paying employees, etc. The formulation of a scientific regime of allocation requires recognition of these inherent factors, which vary from business to business.

699. Any formula that is applied in lieu of an independent factory price established without consideration of tax liability should yield a result that would correspond as closely as possible to an allocation on the basis of such an independent factory price. It is obvious that this result cannot be obtained by apportioning in the ratio of sales receipts, as is done in some jurisdictions, such a factor having the effect of throwing the entire income to the place of sale. Apportionment in the ratio of tangible property, real and personal, has the opposite effect of throwing most of the income to the factory, as most of the property will be located there. Apportionment in the ratio of salaries paid has merit in that the wages paid to employees reflect the relative value of their effort to the enterprise, but it is insufficient for application internationally, because wage scales vary so much from country to country, and it would be difficult to use because of exchange problems. If labour were used as a factor, it could be expressed more easily in terms of hours of employment. Moreover, if the wage scales of the two countries were equivalent and currencies at parity, it would be

¹ *Supra*, paragraph 82.

² *Supra*, paragraphs 50, 249 to 264.

³ *Supra*, paragraphs 280 to 284.

inadequate theoretically, because the income results from the application of work to capital, as represented by real and personal property, and not from work alone.

700. It has been proposed that income should be apportioned on the basis of expense. This would involve, first, an allocation of the items of expense definitely allocable and then an apportionment of general overhead expense and interest on general indebtedness before the income could be apportioned. Two cardinal objections are raised to the application of this method internationally : first, that the cost of doing business varies so greatly from country to country with different transportation costs, wage scales, workmen's insurance, taxes and other items of expense ; and, secondly, there is such a difference in the other economic factors in the country, such as the purchasing power and tastes of the population. Consequently, a relatively large profit may be realised in proportion to expenditure in one country ; but, in another country where the people have less money and different tastes, the receipts may barely cover the expenditure.

701. Nevertheless, apportionment on the expense basis might be justifiable if limited to an apportionment between a factory and a sales office, because it would involve much the same computations and factors as would be employed in determining an independent factory price. The commonly accepted terms to describe the two essential parts of an industrial and mercantile concern are " manufacturing " and " distributing ". The majority of countries recognise that there should be an apportionment of the joint profit of these two parts of a business in some appropriate manner.¹ One theory is that profit is the reward of effort and therefore the joint profit should be apportioned in the ratio of manufacturing effort to distribution or sales effort. Effort can be most readily measured by costs. The joint net operating profit might therefore be readily apportioned in the ratio of manufacturing costs to distribution costs.² The term " manufacturing cost " is perhaps too large, however, in that it implies inclusion of the cost of raw materials which should be excluded because the effort of the factory is expended in converting the raw materials into finished products and therefore the cost of the materials cannot be said to represent manufacturing effort alone, as the materials in their various stages are the reason for expending effort until they are sold.

702. On the other hand, it is doubtful if advertising cost should be included in distribution cost, although it is generally regarded as falling in that category, because it is impossible to measure the direct result of advertising ; even if successful advertising results in the first purchase of a customer, it is the quality of the article itself which prompts him to purchase it a second time, and this may be mostly due to the skill and efficiency of the manufacturing staff. Moreover, if advertising is done in magazines which circulate in adjoining countries with the same language, it is difficult to tell just how the advertising expense should be apportioned. Possibly expenditure for advertising one year may not be effective until the next.

703. Another question is whether the formula should provide for some return on capital invested. The objection may be raised that, in some instances, an enterprise owns its land and buildings, whereas in others it leases premises, and it would therefore be improper to include leased premises unless the rental value were capitalised. Furthermore, it could be said that, if the real property were represented by an interest rate, it would be difficult in the first place to agree on a rate of interest that would apply in the countries involved. Finally, this factor would only serve to complicate the formula.

704. The formula used in Switzerland in apportioning income between the cantons combines practically all the factors previously described, and goes further in that it allots a definite reward

¹ *Supra*, paragraph 94.

² See also " Allocation Accounting ", paragraphs 97 to 106.

to management on the grounds that its productivity is not sufficiently reflected in the accounts of the seat. This *préciput* varies from 10 to 25 per cent. In the example given above,¹ 15 per cent was attributed to the commercial direction in one canton and 5 per cent to the technical direction in another. This same object might be accomplished by using salaries as a factor in companies where the management is well paid, but it is not to be overlooked that the Swiss allow this *préciput* first and then include salaries capitalised at 10 per cent in the productive factors. The balance of the net income is apportioned in the ratio of the productive factors of each establishment, including land and buildings, machines, furniture, stocks and raw materials and merchandise and salaries capitalised at the rate of 10 per cent, as well as items such as cash, bills and accounts receivable.² Although this system may work satisfactorily in a relatively small country in which the tax laws of the various jurisdictions are fairly similar, it would not be as readily applicable as between distant foreign countries because of the difficulty of verifying in detail all the items used in the apportionment.

705. The formula that is gaining in popularity in the United States is that applied in Massachusetts in connection with its corporate excise tax, which is measured by income, but it might readily be employed in connection with income-taxes.³ Certain items which are definitely allocable are first excluded from the income to be apportioned and the remainder is divided in accordance with an allocating percentage which results from averaging the ratios of three factors — tangible property, wages and gross receipts. In other words, the ratio of tangible property in Massachusetts to total tangible property, and of wages and salaries paid in Massachusetts to total wages and salaries, and of gross receipts for goods sold or services rendered in Massachusetts to total gross receipts from all business are added together and divided by three. The resulting percentage is applied to the income to be apportioned. If separate accounting or some modification of the formula is shown to result in a fairer allocation, the tax commissioner may accept it. The advantage of this Massachusetts formula is that it is composed of three factors which are quite readily ascertainable in a country such as the United States and which are well balanced from the viewpoint of the average business, although verification might be difficult if the formula were used internationally. The factor of tangible property may throw practically one-third of the income to the factory, and the factor of gross receipts may throw practically one-third to the place of sale; but the salary factor serves to compensate in some measure for the arbitrariness of the other two factors, in that it apportions one-third of the income in the ratio of remuneration for work done in manufacturing and in selling, presupposing that, in the long run, the salaries or wages paid to individuals are commensurate to the value of their services to the enterprise.

706. It is doubtful if any specific formula should be prescribed in the regime for allocation, especially in view of the fact that there is such a great variety in the formulæ prescribed, that there has been so much litigation carried to the Swiss Federal Tribunal under the Swiss method, and that only a few other American States have adopted the factors in the Massachusetts formula and all admit of deviations to fit the needs of a particular case. Despite all its experience in fixing the percentage representing the relative importance of the local branch to the foreign enterprise as a whole, the Spanish report does not reveal that its Profits Jury has evolved any very definite criteria. The Netherlands East India administration has been upheld by the Board of Tax Appeals in prescribing certain percentages, but it is admitted that they are not binding for all cases. The French administration, in fixing the taxable quota of dividends and interest paid abroad by a foreign corporation which is subject to its tax on income from securities, has liberty to determine, in accordance with the facts of each case, its interpretation of the general terms of the ratio : assets

¹ *Supra*, paragraph 209.

² *Supra*, paragraphs 221 to 231.

³ *Supra*, paragraphs 280 to 284.

in France to total assets (*biens en France à biens totaux*). If a formula were prescribed to apply in cases where no normal market price or independent factory price could be determined or constructed, the Austrian fraction of two-thirds to manufacture and one-third to sale would be the simplest ; but the taxpayer and the tax official should be permitted, in the event that the fraction operated inequitably, to propose modifications to fit the particular circumstances of each case.

707. *Independent Production Price.* — The measure for delimiting the profit of a plantation (e.g., rubber, cotton), mine (e.g., copper, gold, silver), or oil well is fairly well established — *i.e.*, the world or local market price at the date of shipment.¹ If the world market price is quoted in another country, it is appropriate to deduct the cost of transport, carrying charges and insurance from there to the port of shipment, and the selling commission of the agency selling the raw materials.² If there is no world or local market price, the production profit might be determined on the basis of a comparison with those made by similar enterprises and as a last resort by apportionment in the ratio of appropriate factors.³

708. *Remuneration for Processing.* — The most practical method of allocating income to a refinery or other processing establishment is on the basis of what it charges to outsiders for similar services, or if it renders no such services to outsiders, the price that would have to be paid to an independent enterprise for such services.⁴ In the petroleum and possibly other extractive industries, however, there is generally a market price at each stage of production and the profit of an intermediate processing establishment may therefore be easily delimited.⁵

709. Although no profit should be ascribed to buying raw materials or other goods for shipment to another establishment of the enterprise without the country,⁶ remuneration may be allocated to an establishment which grades, sorts or processes the purchased materials before shipment.⁷ If the establishment performs no such services for outsiders, the most practical method of determining a fair rate of remuneration is by considering what would be paid to an independent enterprise for such services.⁸

710. *Remuneration for Other Establishments.* — For other types of establishments which may be considered productive of income, or render services to the enterprise which can be evaluated,⁹ it is impracticable at the present time to do more than prescribe the general method of allocating to it the income that would be derived by an independent enterprise engaged in such activities.

711. *Remuneration fixed in Contract or Statement.* — Assuming that the principles, methods and criteria of allocation are acceptable to administrations, it has been proposed that the method of carrying on operations and the remuneration agreed be stipulated in a contract with a subsidiary, or stated in a resolution of the board of directors or an affidavit of competent officials of the enterprise in the case of a branch establishment. Such contracts have sometimes been used in

¹ *Supra*, paragraph 549 *et seq.*

² *Supra*, paragraph 556.

³ A representative of one company which mines and processes precious metal concentrates states that a production price at some given stage in processing would generally be arbitrary, and suggests apportionment of the consolidated net operating profit in the ratio of three weighted factors : (a) gross profit from sales, 45 per cent ; (b) total property employed, 45 per cent ; (c) aggregate hours of employment of all classes of employees, 10 per cent.

⁴ *Supra*, paragraphs 448 to 450.

⁵ *Supra*, paragraph 555.

⁶ *Supra*, paragraphs 640, 641.

⁷ *Supra*, paragraph 643.

⁸ See also "Taxation of Foreign and National Enterprises", Vol. V, paragraphs 127 to 131.

⁹ *Supra*, paragraphs 643 to 647. See also "Taxation of Foreign and National Enterprises", Vol. V, paragraphs 132, 133.

the past to limit to a nominal amount the remuneration for services rendered to the enterprise by subsidiaries and have been disregarded or rejected by court action. If the contract conforms to the agreed tests of what should be allotted to a subsidiary, it should facilitate assessing its profits. The same is true of a statement pertaining to the relations between the enterprise and a branch establishment. In either case, the annual declaration of the subsidiary or branch would be verified in the light of the contract or statement, pertinent accounts and other necessary data.

712. *Summary of the Proposed Methods.* — For the purpose of reflecting in the separate accounts of each branch establishment of a foreign enterprise, the income it would derive if it were an independent enterprise carrying on similar activities under similar conditions, various methods have been proposed which are well known in commercial practice. These methods, if properly applied, should automatically divide the operating income of an enterprise between its establishments so as to prevent any overlapping of assessments and recourse to the described methods of fractional apportionment should rarely be necessary. In discussing these various methods, it has been presupposed that an establishment has been engaged in only one type of activity. If, however, an establishment carries on two or more different activities in conjunction with other establishments, the income from these activities could be separated and each class allocated in accordance with the appropriate method.

713. The methods proposed may be classified under two general headings: (1) allocation on the basis of remuneration for services rendered to the enterprise; and (2) allocation on the basis of presuming a sale between the interested establishments at the price which would prevail between independent persons dealing at arm's length. The former category is founded on the very realistic proposition that, as in most instances the real centre of management is at the principal productive establishment of the enterprise, the secondary establishments in other countries, whether engaged in processing, manufacturing or selling, should be regarded as serving the enterprise and remunerated with a fee or commission for services which corresponds to what an independent enterprise would receive for rendering such services. The other category is based on the supposition that each establishment engaged in producing, processing or manufacturing materials sells at an appropriate profit to the next establishment, which in turn sells at a profit to the subsequent establishment, and so on, until the sales establishment, like an independent dealer or merchant, sells the finished product to the public. Under the former theory, income may be deemed to accrue as and when the services are rendered. Under the latter theory, no income arises, in principle, until the goods have been sold to an outsider, at which moment the book profit to each establishment definitely accrues. An exception to this proposition has been suggested in the case where raw materials are produced in one country and transferred to an establishment in another, which combines them with other materials in manufacturing a product for sale in the second and also in third countries. The reasons for this exception are that it would be impracticable to try to trace these materials through to their final sale, where their identity is largely lost in the process of manufacture. It has been proposed that, in this case, the profit that would have accrued to the first country if the raw materials had been sold at the world market price on the date of shipment to the second establishment be regarded as taxable there, unless any loss resulting from the eventual sale of the same materials or products made from them can be specifically traced back. It has also been proposed that, where world market prices exist for raw materials in their stages before and after processing, such market prices may be used for delimiting the gross profit allocable to the processing establishment.

714. As regards other types of establishments, it is recommended that the selection of the method should depend, in so far as possible, upon recognised methods of operation for the particular types of enterprise and upon practicability. The method chosen should not only be the most convenient from the viewpoint of the taxpayer, but should facilitate verification by the tax collector

through reflecting in the accounts of the branch and supporting data all that is necessary to compute the taxable income.

As the tax is on net income, it is necessary to show the gross income or profit allocable to the given establishment and the related expenses, losses and other deductions allowable under the law of the country in which the establishment is situated. Where income is allocated on the basis of remuneration for services rendered, there is attributed to such an establishment the gross amount of remuneration, whether in the form of a fee paid per unit of production, or a certain percentage of sales receipts or commission, and the balance of the income is allocated to the real centre of management. The net taxable income is equal to this gross amount less the actual expenses of the establishment in handling the goods. As the goods remain the property of the enterprise until sold, all expenses and losses incident to ownership and to the transportation of such property from establishment to establishment are allocated to the real centre of management. On the contrary, if income is allocated by presuming a sale between establishments, the corollary is to presume that the capital and funds borrowed by the enterprise to finance the operation, the management and all the risks of ownership are apportioned between the several establishments in relation to the time that each presumptively held title to the goods. Consequently, to compute the net profit of each establishment, it is necessary to deduct from the gross profit (represented by the difference between the actual or presumptive cost price and the presumptive or actual sale price), not only the actual expenses of the establishment itself, but also the transport cost and insurance from the preceding establishment, interest on funds borrowed to finance the operation on which it is engaged, and a presumptive share of the losses of the enterprise which can be ascribed to such establishment. If, however, an adequate proportion of the items of general overhead of the enterprise were included in the transfer price to the establishment, an additional part thereof should not be deducted in computing its net income.

715. It is obvious that this latter method cannot readily be applied in practice unless a given establishment is fairly autonomous. If the establishment were also provided with an adequate capital to carry on its activities, which might be necessary in certain countries where there is a tax on capital, this method could more easily be applied. If, however, the branch establishment is an ordinary sales branch, or a processing establishment, the application of this method involves too many assumptions to be practicable. Moreover, it is probable that if a dealer's discount were allocated to an establishment and all the local and imputed items of expense were deducted, the net income remaining would be fairly equivalent to that which would result in attributing a fee or commission and deducting the local expenses of the establishment. It is a significant fact that whereas dealers' discounts average about 15 or 20 per cent of the list price at which branded articles are sold to customers, a fair rate of commission is 5 per cent. These figures are, of course, exemplary, as rates vary greatly from trade to trade. As a prerequisite for allocation methods is simplicity and practicability, it is recommended that the method of remuneration for services rendered be applied wherever possible.

716. Briefly, the fundamental obligation of the taxpayer is so to conduct the intra-enterprise operations that the separate accounting for each establishment reflects its taxable income. If the indicated methods of operation are followed, this result should be achieved. If the business of the taxpayer is such that neither one of the indicated methods can be employed, he should be permitted to show that his accounts regularly maintained on another basis adequately reflect the taxable income of the given establishment, or to propose an appropriate method of apportioning the joint income of two or more establishments.

BANKING AND FINANCIAL ENTERPRISES.

717. It is proposed that, as a general rule, the allocation of income of banks operating in two or more countries be effected on the basis of a separate accounting for the branch or branches

in each country, treated as if they were independent banks.¹ This presupposes that transactions between the head office and the various branches, or between the various branches themselves, will be carried out, in so far as feasible, on the same basis as they would with other banks or clients in order to reduce to a minimum the questions of determining what part of the joint profits of two or more establishments, and also what part of the joint expenses of two or more establishments and of the general overhead expense, is allocable to each establishment.

718. A strict application of the principle of treating a branch like an independent bank would involve allotting to the branch the same amount of capital it would have if it were an independent bank, but such an immobilisation of capital would be most undesirable. One of the advantages of branch banking is that it assures the free flow of funds from places where they are not being used to places where they are most needed. As the unhampered movement of funds is essential to international business, any allocation procedure for banks should be designed to facilitate such transfers of funds as much as possible.

719. The items of income of a bank operating internationally consist of, first, items that are clearly allocable to a definite source, either in the country of a branch or in the country of the head office ; secondly, income derived by an establishment in one country from effecting transactions in other countries where there may or may not be a branch ; and, thirdly, income resulting from intra-company transactions, described by British authorities as " interlocking transactions ", which give rise to difficult questions of allocation.

Income allocable to a Definite Source.

720. The items of income which are definitely allocable to the branch and subject to taxation in the country in which it is situated include :

- (1) Interest received in respect of deposits by the branch in other banks within the country in which the branch is situated ;
- (2) Interest on loans by the branch to outsiders resident within the country of the branch ;
- (3) Income from discounting by the branch commercial paper issued by local corporations and bills of the Government of the country of the branch ;
- (4) Income realised by a branch from dealing in foreign exchange ;
- (5) Profits realised by a branch from purchasing and selling securities within the country ;
- (6) Income received by a branch from investments in securities issued by corporations resident in the country of the branch ;
- (7) Profits or commissions received by a branch from underwriting and/or selling within the country an issue of securities (regardless of where the issuing entity is domiciled) ;
- (8) Fees and/or commissions received by a branch for effecting collections or rendering services within the country ;
- (9) Rents received from leasing office space in buildings owned or leased by the branch, and located within the country of the branch ;
- (10) Rent received from leasing safe-deposit boxes by the branch.

721. For purposes of allocation, these same rules apply to the head office or principal establishment of the banking enterprise.

¹ *Supra*, paragraph 466 *et seq.*

Income attributable to Two Sources.

722. If a branch makes deposits for its own account or for the account of the head office (*nostra* account) in a bank in another country, the interest on such deposits may be subjected to taxation in two or even three countries : first, by the country in which is situated the bank that pays the interest ; secondly, by the country in which is situated the branch receiving the interest ; and, thirdly, by the country in which is situated the bank's head office, by reason of liability to its tax on the basis of total net income. The liability in the second country is due to the fairly general practice of treating the funds of a bank like the stock-in-trade of a commercial enterprise, and to assign income from dealings in such funds to the branch which effects such dealings, regardless of the fact that the income may be taxed as a separate item in the country of source and again as a part of the total net income in the country of fiscal domicile. The same is true of interest on loans to borrowers who are resident in third countries, such interest being subject sometimes to tax by withholding at source at the residence of the borrower ; secondly, at the branch which receives such interest and includes it in the general receipts from its activities ; and, thirdly, in the country where the banking enterprise has its fiscal domicile. The same treatment may be applied to income from foreign securities held in the portfolio of the branch. Dual and even treble liability may also arise in respect of interest on customers' foreign currency accounts.

723. In order to restrict the interested countries to *one* country of source, which may or may not — according to the case — be the same as the country of domicile, it is necessary either to deprive the country in which the debtor of the interest resides of its tax on such interest, or else to exclude such items from the taxable income of the branch itself. With regard to commercial enterprises, it is proposed that they be taxable only in countries in which they have a permanent establishment, and that, if a branch in one country sells to customers in another country in which there is no permanent establishment, the income from such transaction shall be assignable to the branch in the first-mentioned country. If an analogous solution were applied in the case of banks, the country of residence of the debtor, in which there was no branch of the lending bank, would forego its tax in favour of the country in which was situated the lending branch.

724. In the case of banks, however, this principle should be extended even to the case where a branch in one State makes deposits in banks in a State where the enterprise has a branch because, in the same manner as an independent bank, it often has correspondent banks in the same city as the branch or in other cities in that State and has to keep deposits with them in order to meet drafts or exchange contracts or for other purposes. As it is desirable to remove all obstacles to the flow of money, it is recommended that the permanent establishment rule thus understood be applied to banks, with the consequence that if a branch in one country makes deposits for a customer's account, or for its own account, or for head-office account, in another bank, even in a third State where the enterprise has a branch, the interest on such transactions should be allocated for tax purposes to the country of the branch which makes the deposit. In order to remove further tax barriers to the flow of money, the same rule should apply to interest on loans to borrowers other than those considered as investments in the next paragraph (725), and for reasons of practicability to income from purchasing and selling securities in the third country, from underwriting securities issued by a corporation in the third country, and income from exchange and other transactions carried out in the third country.

725. If, however, the branch invests funds in stocks or bonds of corporations in the third country, or invests in real-estate bonds or in mortgages issued on real estate in the third country, it seems desirable that, for purposes of allocation, the third country's right to tax such income from sources in its territory be recognised. Under its laws or treaties, the third country may elect to

exempt such income from its tax, and such income may remain taxable as part of the income of the branch in the second country and also as part of the total net income taxable at the domicile of the banking enterprise, unless the two countries agree to some rule to prevent double taxation. If the country of source taxes such income, it may be subject to triple taxation. If the prior right of the country of source is exercised, double taxation could be prevented by the country of the branch giving a credit against its tax in respect of the tax paid at source, and by the country of fiscal domicile giving similar relief against its tax on total net income.

Income from Inter-branch Transactions.

726. If a branch buys and sells foreign exchange (bills drawn in currency of another country, foreign currency transfers and foreign currencies) for spot or future delivery, the profit or loss resulting therefrom is obviously allocable to the branch. The rule should be the same in whatever market the exchange is bought or sold, whoever the other party to the operation may be — whether the head office, another branch, or an outside party, and even if the transaction with the outside party is effected through the agency of another branch — and irrespective of whether it is a direct operation or an arbitrage transaction involving three or more countries. All exchange contracts to which the branch is a party, as either buyer or seller, should be reflected on its books and only these contracts should be included in calculating the profit or loss accruing to the branch.

727. The same general principles should be applied to the purchase and sale of securities which are quoted on the exchanges of two or more countries.

728. If a branch discounts a bill of exchange or a Government bill and transfers it to a branch in another country, each branch should receive that part of the interest or discount which corresponds to the time during which the paper was carried in its assets. The same rule should apply to any bond or certificate of indebtedness which is transferred from one branch to another.

729. Compensation for taking drafts or cheques for collection should be allocated to the branch which takes the cheque and not to the branch which collects from the drawee.

730. If a banking enterprise undertakes, whether alone or in a syndicate, to underwrite or purchase bonds issued by a corporation or other entity in one country which are to be sold in another country, the entire profit accruing to the enterprise should be deemed to arise at its head office, as it is there that the direction of the operations and the risks involved are centred. Nevertheless, each foreign branch which participated either in securing the loan, negotiating its terms, or selling the bonds should be assigned a commission or other remuneration which is commensurate to the value of its services, and should therefore be acceptable as a basis for the income-tax.

Allocation of Deductible Interest.

731. Perhaps the most difficult question of allocation for banks is determining the allowable deductions for interest. A large part of a bank's earnings are derived, of course, from making loans to outsiders, for which interest is paid to the bank. Normally, from the gross amount received from such dealings in money, there should be deducted the cost of the money itself (*i.e.*, interest paid to depositors or to lenders).

732. As a general rule, a banking enterprise may not deduct interest on its own capital funds, which term includes capital, surplus and undivided profits; on the other hand, it may deduct interest actually paid on the deposits of its clients and money borrowed from other banks. In some countries, the bank or branch may be required to deduct or withhold tax from interest paid to depositors or other creditors, but this tax is on the creditor, and the bank or branch merely serves as collecting agent for the Government.

733. Where a banking corporation with its head office in country A has branches in countries B, C, D, each of which receives deposits, the problem arises in each country as to the amount of the deduction to be allowed in respect of interest. If each branch had sufficient capital and deposits to meet the demand for loans, no problem should arise, because a deduction from its gross income should be allowed for the interest actually paid to depositors. Most branches, however, operate to a greater or less degree on credits or advances received from the principal establishment of the bank, or branches in other countries. Such advances may consist partly of the bank's capital funds, partly of funds borrowed from other banks, and partly of funds from deposits. The interest due to outsiders on deposits in and loans to the bank's establishments in other countries would be deductible in those countries, and the question arises as to whether a deduction for interest should be likewise allowed to the branch which receives an advance out of such funds from another establishment of the bank and makes loans to outsiders.

734. It is customary for the head office or each branch to charge interest at the current local market rate in respect of the amount advanced to a branch in a foreign country, and for such branch to charge interest at the current market rate if it in turn advances funds to the head office or another branch. The interest paid to depositors may be greater or less than the current inter-bank lending rate, depending on the market conditions or banking requirements in the country concerned, but, as this same situation prevails in the case of independent banks, the inter-bank lending rate should be acknowledged as an appropriate basis for advances or loans between branches which are treated in so far as possible as independent banks. This system has the advantage of reflecting clearly the gross profit earned in a given country — *i.e.*, the difference between the cost of the money at the current market rate in the country from which the funds came and the interest rate received for the money in the country in which the funds were lent to third parties.

735. Briefly, the interest rate for funds supplied by one establishment to another in the form of an advance, loan, overdraft or otherwise should be the same as that prevailing between banks for similar transactions in the same currency in the country of the creditor. It is assumed that any establishment of a bank will be given the best terms of credit by another establishment and that it will borrow in the country where the rate is lowest. If one establishment makes a *bona-fide* deposit in another establishment — for example, for the purpose of meeting drafts or exchange commitments — the rate prevailing in the country where the deposit is made should, of course, be used.

736. There is one difficulty, however — namely, the disallowance of interest on the bank's own capital, whether in the country of the head office or in that of the branch. Although, as a rule, an amount fairly equivalent to the bank's capital funds is invested in bank buildings and Government securities and held as cash in the country of the head office, in fact the capital funds and the deposit and borrowed funds become mingled, and it is impossible to say just what proportion of funds used for a particular purpose is out of capital, surplus and undivided profits and how much is out of deposits and borrowings. If a branch is not allotted a permanent capital which is adequate for its particular needs, it may be assumed that the entire amount of capital (which term includes capital, surplus and undivided profits) of the enterprise backs the deposits and other liabilities of the branch just as it backs all the other liabilities of the enterprise. In short, one may assume that the ratio of capital funds to liabilities at the branch is the same as that throughout the entire enterprise. Interest received from lending bank funds (whether out of capital, deposits or borrowings) to outsiders may be regarded as income to the establishment which made the loan. Interest paid by a branch to outsiders on deposits or borrowings is a deductible expense for the branch. As one part of the enterprise is not permitted to charge another part interest on the enterprise's own capital, an adjustment must be made, however, when interest is charged on inter-establishment loans. If the proportion of capital to liabilities is deemed to be the same throughout the entire enterprise, it may be assumed that the same proportion obtains in every inter-establishment

advance. Likewise, interest received on such advances may be considered as accruing in the same proportion to capital funds and to deposit or borrowed funds. Interest charged on inter-establishment advances should be regarded as income to the lending establishment and as a deductible expense to the debtor establishment, except in so far as the interest relates to capital contained in the funds advanced. In other words, the excludable interest pertaining to capital is the same percentage of total interest on inter-establishment advances as the enterprise's capital (including surplus and undivided profits) bears to the total of its capital and of its liabilities to outsiders (deposits and borrowings).

737. The preceding considerations are taken into account in the general rule proposed below for the allocation of interest on inter-establishment advances.

Where one establishment of the enterprise is in the position of a creditor or debtor in relation to another establishment of the enterprise, the following provisions shall apply :

(1) If a permanent establishment in one State (creditor establishment) supplies funds, whether in the form of an advance, loan, overdraft or otherwise, to a permanent establishment in a second State (debtor establishment), for tax purposes interest shall be deemed to accrue as income to the creditor establishment and as a deduction from gross income to the debtor establishment, and such interest shall be computed at the inter-bank rate for similar transactions in the country where is situated the creditor establishment.

(2) Contrary to the provisions of the preceding paragraph, from the interest accruing as income to the creditor establishment and deductible from gross income by the debtor establishment there shall be excluded the interest corresponding to the permanent capital allotted to the debtor establishment in the form of advances, loans, overdrafts or otherwise.

(3) If the interest pertaining to the permanent capital necessary for the operations of the establishment cannot be determined on the basis of its own accounts, such interest may be deemed to be the same proportion of the interest charged on advances, loans, overdrafts or otherwise as the total of the capital (which term includes capital, surplus and undivided profits) of the enterprise bears to the total of its capital and of its liabilities to outsiders (deposits and borrowed funds) at the close of the previous accounting year of such enterprise ; the rate of exchange used in determining said ratio shall be the closing market rate for wire or cable transfers used by the head office for the exchange quotations of the currencies in the States where the branch establishments are situate.

(4) If one establishment places funds with another establishment in the form of a deposit for regular business purposes, interest at the rate for such deposits in the country of the debtor establishment shall be deemed to accrue as provided in paragraph (1) above ; and, if the interest pertaining to the capital necessary for the debtor establishment cannot be computed on the basis of its own accounts, there shall be excluded from the interest charged on deposits the part of such interest which pertains to the proportion of capital deemed to be included in the funds deposited, in the manner provided in paragraph (3) above.

738. The application of the preceding formula will in most instances be facilitated by the fact that banks generally make up a consolidated balance sheet at the close of each accounting year which indicates clearly the figures used in computing the percentage, and also by the fact that the market rates of exchange in the country of the head office are to be used. In practice, once the percentage has been computed, it will be applied to the net balance of interest due to or payable by each establishment to the other establishments of the enterprise.

General Overhead.

739. With regard to general overhead, a part of the general overhead of the head office may be expended directly or indirectly on behalf of a branch, in addition to the amounts regarded

as the overhead expense of that branch. The items of expense of a branch which are definitely allocable to it are, for example, salaries and wages of local officers and employees, rent for premises, depreciation, repairs, taxes, heat, light and supplies. The items of general overhead of the home office which pertain directly to a branch include the salaries of officers and employees who are employed in supervising the branch or representing it in its relations with the home office, keeping or auditing its accounts, and the like. Such items of compensation for direct labour and other expense are susceptible of definite allocation to the given branch.

740. There are other items which benefit the enterprise as a whole, such as salaries of the general officers of the bank, and could, in principle, be apportioned in some appropriate manner between the various units, but no rule for such an apportionment is recommended because, as a matter of policy, most banks do not charge a foreign branch with a proportionate part of these items of general overhead.

Losses.

741. The losses on loans or other operations of banking enterprises should be allocated to the branch to which the income from such transactions would have been allocated under the above principles. The net profit or loss of a given branch, however, should be determined for tax purposes without regard to the net profit or loss of the enterprise as a whole.

INSURANCE ENTERPRISES.

742. So many countries have special legislative provisions¹ concerning the taxation of insurance enterprises and so few complaints have been presented concerning allocation under those provisions that it appears unnecessary to embody in the contemplated treaty any special rules or methods for application in the first instance with regard to enterprises engaged in any class of insurance. In the event, however, that any insurance enterprise should suffer double taxation from its being subjected to the allocation provisions contained in the laws of the various States in which it has permanent establishments, it is recommended that such an enterprise be allowed to request that each permanent establishment be assessed on the basis of the same proportion of the total net income of the enterprise as the premiums paid to each establishment for risks insured in the country bear to the total premiums paid to the enterprise.

TRANSPORT ENTERPRISES.

743. With regard to land transport enterprises, the soundest principle of allocation is that of allocating to a given State the gross receipts and related expenses, losses and other allowable deductions which pertain to the services rendered in such State, and this rule is now followed almost universally.²

744. Nevertheless, to take care of land transport enterprises which cannot reflect their taxable income in the separate accounts maintained in each State where they have permanent establishments, certain principles of apportionment should be recognised which will protect them from cases of double taxation that might arise.

745. It is therefore recommended that a provision should be inserted in the treaty to permit, where the above-mentioned principle cannot be carried out, an agreement for apportionment of the net income of railroad enterprises derived from supplying passenger-car or sleeping-car service

¹ *Supra*, paragraph 490 *et seq.*

² *Supra*, paragraph 512 *et seq.*

in the ratio of the number of cars per mile or kilometre of tracks travelled in the country to the total car-miles or car-kilometres of such services ; and that the net income derived from carrying freight be apportioned in the ratio of ton-miles or ton-kilometres of transportation within the State to the total ton-miles or ton-kilometres of such service.

746. In the case of autobus enterprises, recourse could be had to the apportionment of the total net income in the ratio of the total number of autobuses used per mile or kilometre of roads travelled in the State to the total autobus-miles or autobus-kilometres of such service. ¹

747. As regards maritime navigation enterprises, the principle has been almost universally recognised that their income should be taxable only in the State of fiscal domicile. ² This principle of taxation only at fiscal domicile, or of reciprocal exemption from taxation in States other than that of fiscal domicile, was likewise recommended for general adoption in the case of air navigation enterprises by the General Meeting of Governmental Experts held in Geneva in October 1928. ³ The same principle is now applied by some States with regard to lake and fluvial navigation, and it is recommended for general application in the case of enterprises engaged in such services. ⁴

748. The few jurisdictions which have not adopted the principle of reciprocal exemption now have in their laws methods of computing the taxable income of foreign maritime navigation companies. It is recommended that if such States continue their present methods of allocation they should observe the limitation that the amount of income thus assessed to tax shall not exceed the same proportion of the total net income derived from freight or passenger service as the receipts for outgoing freight or passenger service from such State bear to the total receipts from such services.

749. This same limitation should be applied in the case of lake navigation enterprises. If the State does not apply the principle of reciprocal exemption in the case of fluvial navigation enterprises, it is recommended that the assessment made under its existing laws should not exceed the same proportion of the total net income derived by the enterprise from transporting passengers or freight as the number of boats used per mile or kilometre travelled within its territorial waters bear to the total boat-miles or boat-kilometres of such service.

750. Likewise, if a State does not apply the principle of reciprocal exemption in the case of air navigation enterprises, it is recommended that the assessment under its existing laws shall not exceed the same proportion of the total net income derived from transporting passengers or freight as the ratio of the number of planes per mile or kilometre of distance flown in such State to the total plane-miles or plane-kilometres of such service.

POWER, LIGHT AND GAS ENTERPRISES.

751. As enterprises supplying power, light and gas seldom operate across State frontiers, ⁵ it is not considered necessary to formulate any special provisions concerning them ; the general recommendations concerning taxation on the basis of separate accounting ⁶ should be sufficient to cover them.

¹ *Supra*, paragraph 524.

² *Supra*, paragraph 525 *et seq.*

³ See League of Nations document C.562.M.178.1928.II, Draft Convention No. 1a, Article 5, last paragraph, page 8 ; Draft Convention No. 1b, Article 2B, last paragraph, page 16 ; Draft Convention No. 1c, Article 3, last paragraph, page 19. See also *supra*, paragraphs 536 and 537.

⁴ *Supra*, paragraph 535.

⁵ *Supra*, paragraph 538 *et seq.*

⁶ *Supra*, paragraphs 671 and 672.

TELEGRAPH, TELEPHONE, RADIO AND CABLE ENTERPRISES.

752. As regards telegraph, telephone, radio and cable companies,¹ in general, the volume of traffic in one direction approximately equals the volume in the reverse direction, because the average message gives rise to a reply by the same medium of communication. However, it sometimes occurs that the word rate is greater in one direction, between two given countries, than in the reverse direction. Consequently, even though the volume of traffic may be equalised as to direction, the income flowing therefrom is not necessarily equalised between the two countries. There is also the complication that senders in one direction may tend to use deferred service, with lower rates, more than those in the reverse direction, so that the income by countries is not necessarily in direct proportion to words transmitted.

753. These and other factors tend to make difficult the problem of equitable apportionment of income between countries, but the basis of "origin of messages" is, in the long run, believed to be as equitable a basis as any, and it is perhaps the most simple basis of apportionment. Under this basis, operating receipts (after payout for transmission beyond the company circuit) are allocated to the jurisdiction in which the message originates on the company's circuit.

754. It is fundamental that the establishment of a communications business within a jurisdiction will not be undertaken unless the management is convinced that the income from messages originating in that jurisdiction will give a fair return over and above the expenses of operating in that jurisdiction. The expenses of operating here considered would doubtless be all direct operating costs within that jurisdiction, except operating costs applicable to "through" or "transit" messages neither originating in nor destined to that jurisdiction, and a proportionate part of overhead expenses. Obviously, expenses incurred in that country in the handling of "transit traffic" are not proper charges against the income allocated to that country on the "origin of message" basis.

755. The local books ordinarily reflect the entire tolls for prepaid messages, before payouts to connecting lines, as well as the amounts collected on incoming "collect" messages. To arrive at income on the "origin of message" basis, it would be necessary either to compute the amount of payouts at local offices, and record this in local books, or to obtain this data from the head administrative office. The outgoing collect message income would also be obtained from the head administrative office, as this data is not available locally.

756. From the receipts allocable to a permanent establishment on the origin-of-message basis, there should be deducted, not only the payouts to other companies for transmitting messages originating to such establishment, but also the transit expenses pertaining to such messages which are incurred by the company's establishments in other countries.

757. The other deductions allocable to an establishment should include all items of direct operating expense incurred at that establishment, including a reasonable allowance for depreciation of property, other than ocean cables, maintained by the establishment. The part of the operating expense which pertains to transit of messages originating at establishments in other countries should of course be allocated to such other establishments. If it is impracticable to show in the accounts pertaining to an establishment in one country such charges made to establishments in other countries, the amount thereof could be computed on a "word basis". The equation would be: The handling expenses of transit traffic are to total handling expenses as transit words are to total words handled. As telegraph, radio and cable companies usually maintain statistics of

¹ *Supra*, paragraph 542 et seq.

words transmitted, the data necessary to make this equitable segregation of expenses should be readily available.

758. The deductions should also include a proportionate part of the expenses pertaining to the enterprise as a whole, and not to any one establishment, such as general administrative expense, expense of operating relay stations not themselves productive of income, and depreciation of ocean cables. This proportion should likewise be determined on the origin-of-message basis — *i.e.*, by the ratio of words originating at the establishment to the total words transmitted by the enterprise.

MINING AND AGRICULTURAL ENTERPRISES.

759. Mining or extractive industries of all kinds¹ have been treated in conjunction with industrial and mercantile enterprises,² because practically the only cases of allocation that arise are where the mine is in one State and the sales establishment is in a second, or the materials mined or extracted are shipped for processing or manufacture to another State. The same is true of enterprises owning rubber, rice, sugar, tea or other plantations.

OTHER KINDS OF ENTERPRISES.

760. Practically the only other enterprises which have given rise to questions of allocation are those which produce moving-picture films in one State and lease them to distributors in a second.³ It is recommended that such enterprises be assimilated in so far as possible to enterprises manufacturing in one State and selling in another, in order that the profit derived from producing and distributing the films may be fairly apportioned between the two States. If the whole income derived from leasing the films to distributors in the second State is regarded as a royalty, the whole profit would be allocated to the State where the film is shown and none would be allocated to the State where the film has been produced. Consequently, where the enterprise produces films at a permanent establishment in one State and leases them through a permanent establishment in a second State to moving-picture houses in a second State or in a third State, it is recommended that only a reasonable commission on, or part of, the rentals received by such distributing establishment in the second State be allocated to such State and that the balance of the income be allocated to the first State as the equivalent of the profit attributable to production. Such an enterprise may be assimilated to one which manufactures machines or other movable property in one State and leases such property through its permanent establishment in a second State to persons in such State. Clearly, a reasonable part of the rentals should be regarded as income attributable to the manufacturing plant.

PROCEDURE.

761. In the preceding paragraphs, principles and methods of allocation have been advocated which, if followed in goodwill by the taxpayer and the tax collector, should result in preventing double taxation of the same income on grounds of source. In general, the procedure is to classify the various items of income of the enterprise and allocate each to its separate source. For the enterprises which derive income from the production and sale of goods recognised and practical commercial methods have been proposed which, if properly applied, should automatically divide the income between establishments which have participated in producing it. The very nature of the operations of banking and communications enterprises has permitted the formulation of

¹ *Supra*, paragraph 549 *et seq.*

² *Supra*, paragraph 632 *et seq.*

³ *Supra*, paragraph 566.

precise rules for allocating the various items of income and related expense. So few problems have arisen in practice in connection with other types of enterprises, that it has not been necessary to do more than prescribe general principles and indicate certain safeguards. For most enterprises the observance of the basic principles of the regime should preclude the superposition of source taxes.

Nevertheless, it is expedient to envisage the possible occurrence of disagreements as to the meaning of provisions of the contemplated treaty or the application of its principles or methods.

As regards industrial and mercantile enterprises, whatever the method applied in the case of a given branch establishment of a foreign enterprise, it should be applied consistently as long as the situation of the establishment remains essentially the same. If, for example, the income of a sales establishment is first determined on the independent commission basis, and the establishment grows and becomes a more or less autonomous mercantile establishment, there may be reason to shift to the independent dealer's price basis.

762. As the very purpose of the allocation regime is to prevent the double taxation resulting from two countries claiming tax on the same profits on grounds of source, it is essential that the two (or more) countries in which there are establishments co-operating in the production of income should be in accord as to the method of dividing it between them. To avoid disputes, the contemplated treaty should indicate the method considered most satisfactory for a particular type of establishment, for example, the independent commission basis for the ordinary sales branch. When the circumstances are such that either the commission basis or the independent dealer price might be used, obviously the taxpayer, assuming its tax integrity to be above reproach, can best decide which method is most appropriate to employ. The method selected by the taxpayer must of course be acceptable to the tax authorities of the country in which the given establishment is situated. The authorities of that country should have the prior right to determine its reasonableness, in the light of the treaty provisions, because they have full jurisdiction over the activities of the establishment. It is only in the case where the method, or the rate of commission or dealer's price is clearly unreasonable that the other administration (ordinarily that of the country of fiscal domicile) should object. Obviously, if the taxpayer prefers recourse to fractional apportionment of the joint income of two or more establishments it should secure agreement from all interested administrations concerning the factors to be employed. If two or more administrations make assessments which overlap, the taxpayer should appeal, in the ordinary manner against the assessment which, according to the letter or the spirit of the convention, is excessive. If the claims of both administrations are excessive, it should be permitted to request the administration of the country of fiscal domicile to communicate with that of the other country, or if the administrations involved are both foreign, it should be allowed to request both of them to endeavour to come to an equitable settlement. If the dispute cannot thus be settled by agreement between the interested administrations, the taxpayer should be permitted to appeal, either through the Government of the country of its fiscal domicile, or directly, to some factual commission appointed by the League of Nations or to the Permanent Court of International Justice.

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ABBREVIATIONS.

British Commonwealth of Nations.

British India.

- A.I.R. — All India Reporter.
- Cal. — Calcutta.
- C.W.N. — Calcutta Weekly Notes.
- I.L.R. — Indian Law Reports.
- I.T.C. — Income Tax Cases.
- L.J.K.B. — *Law Journal* Reports, King's Bench Division.
- L.J.P.C. — *Law Journal* Reports, Privy Council.
- L.J.Q.B. — *Law Journal* Reports, Queen's Bench Division.
- Rang. — Sparks Rangoon Decisions, British Burma.
- T.L.R. — *Times* Law Reports.

Canada.

- R.S.C. — Revised Statutes of Canada.

South Africa.

- S.A. Tax Cases — South African Tax Cases.

United Kingdom.

- A.C. — Law Reports, Appeal Cases.
- H. & N. — Hurlstone & Norman's English Exchequer Reports.
- Jur. (N.S.) — Jurist Reports, New Series.
- K.B. — Law Reports, King's Bench Division.
- L.J. Ex. — *Law Journal* Reports, Exchequer.
- L.T. — *Law Times* Reports.
- Q.B.D. — Law Reports, Queen's Bench Division.
- T.C. — Reports of Tax Cases for the Commissioners of Inland Revenue.
- W.R. — Weekly Reporter.

France.

- R.E. — Revue de l'enregistrement.
- S.J. — La Semaine juridique.

United States of America.

- Am. Fed. Tax Rep. — American Federal Tax Reports.
- B.T.A. — Board of Tax Appeals.
- C.B. — Cumulative Bulletin, Bureau of Internal Revenue.

Ct. Cl. — Court of Claims.

E.D.Pa. — Eastern District of Pennsylvania.

F. — Federal Reporter.

G.C.M. — General Counsel's Memorandum, Bureau of Internal Revenue.

N.D. Ohio — Northern District of Ohio.

N.W. — Northwestern Reporter.

S.Ct. — Supreme Court Reports.

U.S. — United States Reports.

Reg. — Regulations.

Sec. — Section.

Art. — Article.

“Collection” — Collection of International Agreements and Internal Legal Provisions for the Prevention of Double Taxation and Fiscal Evasion. League of Nations Document No. C.345.M.102 (1928) II, and supplements.
