New Trends and Prospects for the Distribution of International Taxation Rights with looking at the tradition since the era of the League of Nations

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Abstract

The most important choice in the era of the League of Nations is the adoption of *separate accounting*, which considers a domestic physical presence (which corresponds to the present concept of a “permanent establishment” (PE)) of a foreign enterprise to be an independent enterprise. The idea of *separate accounting*, in which a person (individual or corporation) or a part (PE) that physically contributes to the business income is entitled to a share of the income according to its contribution, is associated with the idea of the labor value theory. In reality, entities sometimes do receive income without contribution, such as in compensation for covenants not to compete. When we allocate income among affiliated enterprises in accordance with the contributions made, there are two types of independent business transactions, or arm’s length transactions, of note: reliable arm’s length transactions, and unreliable arm’s length transactions.

We can find examples of both mild derogation from the arm’s length principle and severe derogation from the arm’s length principle. In one case, Amount B, in which profit is attributable to a place of activities according to fictious rate of return, can be considered as mild derogation from the arm’s length principle, in which transactions like unreliable arm’s length transactions are denied. In another case, Amount A, in which taxing rights are allocated to places of demand, can in no way be justified as mild derogation from the arm’s length principle, and must be considered as severe derogation from the arm’s length principle.

Keywords: international tax law, League of Nations, source rule, permanent establishment, threshold, separate accounting, arm’s length principle

JEL Classification: H25, H26

I. Outline of this article

[*1]This article tries to look at the image of source of income (source has two meanings; {from what} and {from where} which is called as geographical allocation of income in this article) in the traditional international tax law system since the era of the League of Nations, in order to deeply understand contemporary change of international taxing rights allocation (especially allocated to a place of demand).

[*1] In this article, no job title or honorific title is added to a person’s name. “ ” or ‘ ’ is used for quotations, and { } is used for clarification. YYYYMMDD is used, and MMDDYYYY or DDMMYYYY is used only in quotations.

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Chapter II reviews the framework of the existing international tax law system.

Section II-1 reviews source of income rules.

Source of income rules have standards for earners (mainly for sales income, service income or other business income) and standards for payers (for dividends income, interest income, royalty income, or etc.). If we consider that source of income rules for dividends income and interest income looks at the place of producing activities of payers, most source of income rules can be consistently understood as according to standard of place of production (although there are differences between place of earners' production and place of payers' production). Nevertheless, because it is difficult to justify source rule of royalty income (due to differences in source rules of dividends income and interest income) looking at place of payers' producing activities, we must recognize that source rule of royalty income is derogated from a consistent understanding of other source of income rules looking at place of production.

Section II-2 discusses the important choices made in the era of the League of Nations.

In the light of constraints of tax enforcement capacity in the era of the League of Nations, when a country (Country S) tried to impose tax on an enterprise of a foreign country (Country R), there was little space of alternatives to require a domestic physical presence (which corresponds to the present concept of a "permanent establishment" (PE)) of the enterprise. In other words, the {no taxation without a PE} rule was not a result of choices made in the era of the League of Nations.

An important choice made in the era of the League of Nations was the adoption of the idea of separate accounting, in which a physical presence in Country S of an enterprise of Country R is considered as an independent enterprise, or the adoption of the idea of consolidation, in which the presence in Country S is considered as a part of international expansion of the enterprise of Country R. Even in that era, there were some thoughts that the idea of separate accounting does not fit with the practical reality of an enterprise's international expansion (the practical reality in which the enterprise creates an alter ego because the enterprise expects to make more profit when creating the alter ego than entering into market transactions with third parties); however, constraints of tax enforcement capacity of Country S of that era had difficulty in acquiring information in Country R in order to enforce tax according to the idea of consolidation, and lead to the adoption of the idea of separate accounting. But, even if we assume the constraints of tax enforcement capacity of that era, if we do not stick with separate accounting and if we have an image, not of the {no taxation without a PE} rule, but of the {no taxation without a PE or an affiliated entity} rule, Country S could have applied the {force of attraction} rule (like the entire income principle in Japan before the 2014 amendment, all Country S' domestic source income, regardless whether attributable to a PE or not, is included into taxable income in Country S in the procedure of tax filing by the PE), not only to a PE of the enterprise of Country R which has only one legal personality, but also to an affiliated entity of the enterprise of Country R without regard to the number of legal personalities. Not only when Country R's enterprise (X co.) has a physical presence as a PE in Country S, but also when X co.'s affiliated entity (X co.'s affiliated corporation established in Country S or a branch established in Country S of X co.'s affiliated corporation not established in Country S) is physically located in Country S, Country S can impose obligation of tax filing on the physical presence in Country S (X co.'s branch, X co.'s affiliated co., or a branch of X co.'s affiliated co.) concerning the income which can be considered as Country S' domestic source income by investigations engaged in Country S by Country S' tax office, regardless whether the income is legally attributable to X co.'s head office in Country R, X co.'s branch in Country S, X co.'s affiliated co. in Country S, X co.'s affiliated co. not in Country S, or a branch in Country S of X co.'s affiliated co. not in Country S, even if Country S cannot gather information in Country R. This idea, in which Country S' taxing right on X co.'s income is not only based on direct nexus with X co.'s physical presence in Country S but also based on indirect nexus, can be considered to resemble the idea in the 21st century which can be found in anti-fragmentation discussion concerning the scope of recognition of a PE. The most important choice in the era of the League of Nations was the adoption the idea of separate accounting, not adopting the {no taxation without a PE or an affiliated entity} rule and the force of attraction rule. Adoption of the idea of separate accounting now, in the existing international tax law system, provides scope in which USA's multinational enterprises erode tax base through business restructuring while laughing at the efforts of countries who try to prohibit base erosion with strict application of the arm's length principle.

Country R   Country S
X co.------------------------------branch
X co.------------------------------X co.'s affiliated co.
X co.---X co.'s affiliated co.---The affiliated co.'s branch

Chapter III discusses what kind of derogation is needed concerning the arm's length principle which is the backbone of the existing international tax law system.

Section III-1 explains the terms reliable arm's length and unreliable arm's length which are not common wordings.

The idea of separate accounting was an idea like labor value theory in which a person (individual or corporation) or a part (PE) that physically contributes to the business income is entitled to a share of the income according to its contribution (nowadays, expressed as value creation). However, in arm's length transactions in the real world, a person who has contributed nothing concerning business income can earn income, as in a case in which the person earns compensation from a covenant not to compete. The legal validity of payments of compensation of covenants not to compete in arm's length settings cannot be denied, but payments of compensation of covenants not to compete between affiliated entities could be denied. If we make a fiction of income earning according to the contribution, we must accept the concepts of reliable arm's length transactions and unreliable arm's length transactions.

Section III-2 discusses mild derogations and severe derogations from the arm's length principle.

As mild derogations from the arm's length principle, we will make a countermeasure in which income attribution recognized by unreliable arm's length transactions even those existing in the real world cannot be applied between affiliated entities. The idea of Amount B[1] which was recently discussed makes a fiction in which local activities must earn a certain minimum rate of return; this idea can be considered as ensuring income attribution according to the contribution by the local activities with the idea of labor value theory. And more, this idea can be considered as denying tax planning of base erosion with unreliable arm's length transactions (income can be attributable to a person or a part according not to their physical contribution) in the country of the place of activities. If we understand the idea of Amount B as above, Amount B can be found to be a mild derogation from the arm's length principle.

Section III-3 discusses severe derogations from the arm's length principle.

The idea of Amount A[2] of taxing right allocation based on a place of demand cannot be justified by discussing relationship between reliable arm's length transactions and unreliable arm's length transactions. It is because Amount A discusses derogations from the traditional international tax law system in which demand alone does not give the base of geographical allocation of income. Therefore, discussion of Amount A can be found to be a severe derogation from the arm's length principle. How can we justify such severe derogations? Subsection III-3-2 tries to give a model, concerning the markets in which so-called network effects have serious impacts, in which mild derogations from the arm's length principle denying unreliable arm's length transactions are not enough to convincingly accomplish taxing rights allocation among countries, and we will need change in thinking (severe derogations) that the geographic allocation of income can be based on demand in a market country.

Chapter IV compares corporation tax and value added tax because taxing right allocation according to demand has traditionally been discussed in the context of value added tax.

II. Outline of existing international tax law system

II-1. Geographic allocation of income and personal attribution of income

Traditionally, when we make an image of a source of income[3] (geographical allocation

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[1] OECD/G20 Base Erosion and Profit Shifting Project: "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy", As approved by the OECD/G20 Inclusive Framework on BEPS on 29-30 January 2020, p. 16 (2020 January 31 http://www.oecd.org/newsroom/international-community-renews-commitment-to-multilateral-efforts-toaddress-tax-challenges-from-digitalisation-of-the-economy.htm).

[2] OECD, footnote 1, p. 9.

[3] Author of this article usually criticizes the concept of global income, but {income} in this article is not concerned with the difference between the concept of global income and consumption-type concept of income. And more, {income} in this article does not necessarily differentiate between gross income (revenue) and net income (profit). {Profit} in this article clearly means net income which is calculated as revenue minus cost.

of income), the standard of the source has long been considered as a place of assets or a place of business. However, as said below, this article states that we do not need the standard of place of assets and we should look at only the standard of place of business. By the way, this article willfully uses an ambiguous expression of {image}, because geographical allocation of income cannot be deductively and logically determined[4] from the definition of income.[5]

See six examples below.

(1) Country R's X co. has an immovable property in Country S, which is rented to Y co., and gets rental income from Y co.
(2) Country R's X co. contributes money to Country S' Y co., and gets dividends income from Y co.
(3) Country R's X co. lends money to Country S' Y co., and gets interest income from Y co.
(4) Country R's X co. has made invention in Country R, has got a patent right in Country S, enters into license agreement of the patent right with Country S' Y co., and gets royalty income from Y co.
(5) Country R's X co. produces tangible properties, sells them to Country S' Y co., and gets business income.
(6) Country R's X co. supplies services to Country S' Y co., and gets business income.

Country R Country S
(1) X co.<---rental income--------Y co.
(2) X co.<---dividends income---Y co.
(3) X co.<---interest income------Y co.
(4) X co.<---royalty income------Y co.
(5) X co.<---sales income---------Y co.
(6) X co.<---service income------Y co.

II-1-1. Rental income of immovable properties

In Example (1), most tax lawyers have an image that the geographical allocation of in-

[4] Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke Law Journal 1021, at 1034 (1997). Note that Graetz & O'Hear (1997) tried to support source tax jurisdiction.

[5] Recently, the idea of LSR (location specific rent) attracts attention in order to justify special taxing rights such as DST (digital service tax). This idea is attractive but this article does not discuss LSR nor DST. Fortunately, 渡辺徹也「デジタルサービス税の理論的根拠と課題—Location-Specific Rentに関する考察を中心に—」フィナンシャル・レビュー143号219-235頁 (2020) (Watanabe, Tetsuya, "Logical foundation and challenge of digital service tax: mainly concerning thoughts on Location-Specific Rent", Financial Review, no. 143, pp. 219-235) considers LSR and DST. Cf. Wei Cui (崔威), "The Digital Services Tax on the Verge of Implementation", 67:4 Canadian Tax Journal 1135-1152 (2019); Wei Cui, "The Superiority of the Digital Service Tax over Significant Digital Presence Proposals", 72:4 National Tax Journal 839-856 (2019); Wei Cui, "The Digital Services Tax: A Conceptual Defense" (unpublished, 2019 April 30 https://ssrn.com/abstract=3273641); Wei Cui & Nigar Hashimzade, "The Digital Services Tax as a Tax on Location-Specific Rent" (unpublished, 2019 July 29 https://ssrn.com/abstract=3321393); Daniel Shaviro, "Digital Service Taxes and the Broader Shift From Determining the Source of Income to Taxing Location-Specific Rents" (unpublished, 2020 January 14 https://www.law.nyu.edu/sites/default/files/shaviro-singapore-lecture-v3.pdf).

come from immovable properties are located in Country S[6] and an image that personal attribution of the income belongs to X co. (and in Country R). Most tax lawyers have long accepted the fact that there can be naturally a discrepancy between geographical allocation of income and personal attribution of income.

I stress with the word {naturally} because, in the context of taxation on subsidiaries (including affiliated corporations) and PEs, there has been a tendency that the geographical allocation of income and personal attribution of income are merged (personal attribution of income is prior and geographical allocation of income is coordinated with personal attribution of income); however, I would like to stress that the tendency is not natural. I will write about the tendency in section II-2, and this section continues to discuss geographical allocation of income.

In Example (1), we can find several reasons of an image that the geographical allocation of income from immovable properties is located in Country S; first candidate of the standard concluding geographical allocation of income is the standard of place of assets in which source of income in the meaning of {from where} is considered to be the place of immovable properties which is the source of income in the meaning of {from what}, which is located in Country S in Example (1); the second is the standard of place of business (differentiated from the third below, the standard of place of business of earners) in which source of income with the meaning of {from where} is considered to be the place of business (immovable properties rent business in Example (1)) which is the source of income with the meaning of {from what}, which is located in Country S; third, is the standard of place of payers (differentiated from the second above, the standard of place of business of payers) in which source of income with the meaning of {from where} is the place of payers' activities which is the source of income with the meaning of {from what}, which is located in Country S. If the payer, Y co. is not a resident of Country S but of a third country (Country T), the third standard has a possibility to lead an image that the geographical allocation of income is located in Country T if the standard of place of payers looks at residency of the payer; however we can ignore the possibility because no tax lawyers will adopt the standard of place of payers' residency concerning immovable property rental income.

By the way, concerning rental income of immovable properties, there is an unignorable size of cases in which the standard of place of payers' business is not suitable. When payers borrow immovable properties for their consumption (typically, in order to live in), the standard is not suitable. Even though explaining geographical allocation of income from immovable properties according to the standard of place of earners' business or the standard of place of payers' business would have not much difference, the standard of place of earners' business would have less difficulties.

II-1-2. Dividends income

In Example (2) of dividends income, tax lawyers have little tendency to have an image

[6] See OECD Model Tax Convention, Article 6.

that the money contribution itself is business of X co. (the contribution in Example (2) and the lending in Example (3) can be considered as a part of business of fund utilization, but traditionally the contribution itself has not been considered as business); it is common among tax lawyers that we have an image that the geographical allocation of dividends income is located in Country S because we look at the fact that the payer of the dividends is Y co. who is a resident of Country S (the standard of place of payers). However, pure form of the standard of place of payers (looking at only residence of the payers) has rarely, if any, been adopted; we have an image that the geographical allocation of dividends income is located in a third country (Country T) if the payer, Y co., does business activities and the business's profit is the source ({from what}) of the dividends payment (the standard of place of payers' business).

In Example (2) of dividends income, we can also explain the geographical allocation of the dividend income as existing in Country S because the source ({from what}) of the dividends is stocks and the stocks' place is determined by looking at the residence of the issuer (Y co.) of the stocks, in short, Country S (the standard of place of asset). Derogating from the context of income taxation, stocks issued by a foreign corporation are not considered as a domestic asset in the context of inheritance tax and gift tax.[7] Returning to the context of income taxation, the standard of place of assets can be considered as the same as the standard of place of payers' residence concerning dividends income; however, the standard of place of payers' business would be more persuasive than the standard of place of payers' residence, so we do not have to adhere to the standard of place of asset.

II-1-3. Interest income

In Example (3) of interest income, as like in Example (2) of dividends income, it is possible to explain that the geographical allocation of interest income is located in Country S because the loan claim is located in Country S (the standard of place of asset). However, as like in Example (2), we should not adhere to the standard of place of asset. And moreover, as like in Example (2), it is usual to explain that the geographical allocation of income is located in Country S because the payer of the interest, Y co., is located in Country S (the standard of place of payers). And, as like in Example (2), we have an image of the geographical allocation of interest income, not relying on the pure form of the standard of place of payers' residence, but relying on the standard of place of payers' business because the source of income in the meaning of {from what} is the business activities of Y co.; if the source of {from what} is the business activities of Y co. located in third country (Country T), then the geographical allocation of the interest income is considered to be located in Country T.

However, Example (3) has points that differ from Example (2). Although it is unusual

[7] In *Takefuji* case, Supreme Court, 2011 February 18th, reported in *Hanrei Jihô*, no. 2111, p. 3, the objects of the gift were stocks (more precisely, 出資口数 (number of capital contributions)) of a Dutch corporation, but the corporation indirectly held stocks of a Japanese corporation (Takefuji). An argument that the objects of the gift were domestic (Japanese) assets is not strange when we look at economic situations in this case. However, the Japanese tax authority did not argue that the objects of the gift were domestic asset because such argument would have little chance in law.

that the money contribution in Example (2) is considered as business activities of X co., the lending of money in Example (3) can be considered as business activities of X co. Let's suppose that X co. has borrowed money (¥8000) from a third party (Z co.) with interest rate of 10% and lends the money (¥8000) to Y co. with interest rate of 12.5%; X co. gets interest income of ¥1000 (gross income) from Y co., pays interest income of ¥800 to Z co., and gets net income (or profit) of ¥200 (ignoring other cost for simplicity). If X co. has business facilities in only Country R, it is possible to have an image that the geographical allocation of the business profit of ¥200 is located in Country R (the standard of place of earners' business). However, on the one hand, when X co. does not have a PE in Country S, it has been rarely seen to have an image that the geographical allocation of interest income (regardless whether net income or gross income) is determined by the standard of place of earners' business.

On the other hand, when X co. has a PE in Country S, it is more widely accepted to have an image that the geographical allocation of the business profit is located in Country S by the standard of place of earners' business. Here, business profit means net income. And what is more, when X co. has a PE in Country S, also dividends income is included into the context of taxation on profits attributable to the PE.[8]

II-1-4. Royalty income

In Example (4) of royalty income, the typical image is that the geographical allocation of the royalty income concerning license of Country S' patent right is located in Country S. We have to note that many existing tax treaties have the {no taxation without a PE} rule concerning royalty income[9]; there is a complication that the geographical allocation of the royalty income is located in Country S but Country S' taxing right is prohibited.[10] Even with this complication, there seems to be little space to argue that the geographical allocation of the royalty income is not located in Country S.

Why do we have such an image of the geographical allocation of royalty income? It is because Country S' patent right is definitely located in Country S, in the light of the idea of the principle of territoriality in intellectual property law textbooks.[11]

In this regard, tax professionals sometimes say that intangible properties can be easily transferred across borders internationally; however, not concerning all intangible properties but, at least, concerning intellectual properties like patent rights, we should think that the rights cannot be transferred across borders as well as immovable properties.

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8 See OECD Model Tax Convention, Article 10(4) (PE taxation on dividends income) and Article 11(4) (PE taxation on interest income).

9 Compare OECD Model Tax Convention, Article 12(1) (allocating taxing rights on royalty income only to Country R in example (4)) and Articles 10(2) and 11(2) (allocating limited taxing rights on dividends income and interest income to Country S). Also see UN Model Tax Convention, Article 12(2) (allocating limited taxing rights on royalty income to Country S).

10 In many countries, domestic tax law allocates taxing rights on royalty income to Country S in Example (4) if the country's taxing rights are not restricted by a tax treaty.

11 Paris Convention for the Protection of Industrial Property, Article 4 bis (Independence of Patents Obtained for the Same Invention in Different Countries) (https://wipolex.wipo.int/en/text/287556); See, 田村善之『知的財産法　第2版』444頁（有斐閣, 2000）(TAMURA, Yoshiyuki, "INTELLECTUAL PROPERTY LAW second edition", p. 444, Yûhikaku, 2000).

If it is right statement that intangible properties can be easily transferred across borders, there can be two possibilities.

The first possibility is that although patent rights are governed by the Paris Convention's principle of territoriality, there can be a space in which not all intangible properties are governed by the principle of territoriality. However, I have not yet found such statement that intellectual properties are governed by the principle of territoriality but other types of intangible properties can be easily transferred across borders. In international tax law discussions, the difference of transferability across borders between intellectual properties and other types of intangible properties has not gathered attraction. Therefore, this article ignores this first possibility.

The second possibility is that although patent rights or other intellectual properties cannot be transferred across borders like immovable properties, it is possible for buying agreements of certain immovable properties to cross borders; therefore, it is possible to see that there can be a transfer across borders of an owner of a right, regardless whether a right of an intellectual property or of an immovable property, and the residence country of the owner of the right can be changed. The second possibility is not wrong. But, have we explained that immovable properties can be easily transferred across borders? If not, we should refrain from explaining that intangible properties can be easily transferred across borders.

As said above in two paragraphs, this article does not say that intangible properties can be easily transferred across borders.

The image becomes less robust as we can see that the geographical allocation of the royalty income is located in Country S according to the standard of place of assets in Example (4), which differs when compared with Example (1) of the rental income of the immovable property. On the one hand in Example (1), it can be easily thought that the business of rental of the immovable property is done in Country S; on the other hand in Example (4), the invention which is base of the royalty income has been done in Country R. If we apply the standard of place of business in Example (4) as well as in Example (1), the geographical allocation of the royalty income should be considered as be located in Country R rather than Country S.

In this regard, readers might have an image that the geographical allocation of the royalty income is located in Country S not relying on the standard of place of earners' business as in Example (1) but relying on the standard of place of payers' business as in Examples (2) and (3), because the royalty income is paid out of the fruits of the business activities of Y co. in Country S. Also in application of Japanese domestic law, we can find examples that, in deciding the scope of royalty income which is subject to withholding tax, people might have an assumption that income is paid out of the fruits of business activities of a domestic payer not relying on the standard of place of earners' business but relying on the standard of payers' business.[12] However, if we can ignore the historical background, and if we can make an assumption that the royalty income is compensation of X co.'s invention in Example (4) (subsection III-2-3 will discuss an example in which this assumption is relaxed), it is strange that the geographical allocation of the royalty income is governed by the place of payers' business as in Examples (2) and (3). OECD Model Tax Convention, Article 12 treats royalty income as located between Articles 10 (dividends income) and 11 (interest income) and Article 13 (capital gain), and this location might give us an impression that royalty income is a kind of capital income; however, if we care about the distinction between financial transactions and real economic transactions,[13] and if it is assumed that dividends income and interest income are earned in financial transactions and royalty income is compensation of inventions, then we should look the invention which is real economic activity (operation of real production factors such as humans, machines, or factories) and the royalty income should be considered as earnings in the context of real economic transactions.

Between the standard of place of assets or the standard of place of payers' business and the standard of place of earners' business, we have different theories of the geographical allocation of the royalty income. This difference gives us an intuition that our image of the geographical allocation of the royalty income is likely to be a watershed among some standards of source of income of {from where}.

This article argues that the standard of place of assets can be absorbed into the standard of place of payers' business. As discussed in Example (2) of dividends income, readers might see that the place of the stocks is considered to be the residence of the issuer, Y co.; however, when the business activities of Y co. which is the base of the dividend income are engaged in mainly third country (Country T), the standard of place of assets would give a counter-intuitive result concerning the image of the geographical allocation of income. In Example (1) of the immovable property, the standard of place of assets seems to fit with an image of the geographical allocation of income in a most persuasive way, but we do not need to adhere to the standard of place of assets because we can reach the same result if we apply the standard of place of earners' business and the standard of place of payers' business. Therefore, abolition of the standard of place of assets would lead to few mistakes.

In Example (4) in contrast to Example (1), the standard of place of payers' business and the standard of place of earners' business leads different results of images of the geographical allocation of income. We need to think carefully. I said {if we can ignore the historical background, and if we can have an assumption that the royalty income is compensation of X co.'s invention in Example (4)}, and this article argues that the standard of place of earners' business is suitable for the royalty income and that the geographical allocation of the royalty income should be considered to be located in Country R, not in Country S. This argument is different from a traditional image that the geographical allocation of royalty income has

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[12] See, 浅妻章如「知的財産権等使用料の範囲と所得配分」相澤英孝＝大渕哲也＝小泉直樹＝田村善之編『中山信弘先生還暦記念論文集　知的財産法の理論と現代的課題』580頁（弘文堂，2005）(Asatsuma, Akiyuki, "Scope and allocation concerning royalty income of intellectual properties", Aizawa, Hidetaka = Ôbuchi, Tetsuya = Koizumi, Naoki = Tamura, Yoshiyuki, ed., In Honor of 60th Birthday of Professor Nakayama, Nobuhiro: Theory and current challenge in Intellectual Property Law, p. 580 (Kôbundô, 2005)).

[13] Distinction between financial transactions and real economic transactions can be difficult in, for example, rental transactions of machines. See footnote 39. Concerning cash flow tax with R base or R+F base, see, 神山弘行「法人課税とリスク」金子宏＝中里実＝J. マーク・ラムザイヤー編『租税法と市場』321頁（有斐閣，2014）(Kôyama, Hiroyuki, "Corporation taxation and risk", Kaneko, Hiroshi = Nakazato, Minoru = J. Mark Ramseyer, ed., Tax Law and Market, p. 321, Yûhikaku, 2014).

been located in Country S (regardless whether relying on the standard of place of assets or the standard of place of payers' business).

This difference gives us serious challenge concerning how we have an image of the geographical allocation of income. This article repeatedly and intentionally uses the word of {image} which is ambiguous. It is because the geographical allocation of income cannot be decided by logic. {Image} and {should} are incompatible. The argument that the geographical allocation of income is only an {image}, not decided by logic, requires us to take another step concerning the geographical allocation of income: even if the source rule of royalty income and the source rules of immovable properties income, dividends income, or interest income lead to different images of the geographical allocation of income, we should try to sublate (*aufheben*) the different images. However, I have not been able to sublate them and no one seems to have.

This difficulty of sublating the different images makes me to argue that the traditional image that the geographical allocation of the royalty income in Example (4) is located in Country S, is incompatible with images of the geographical allocation of other income in Examples (1) (2) (3) (5) and (6). If we can have the assumption that the royalty income is compensation of X co.'s invention in Example (4) (but see, subsection III-2-3), the geographical allocation of the royalty income should be considered to be located in Country R with the standard of place of earners' business.

II-1-5. Sales income

In Example (5) of sales income, if X co. has a PE in Country S, the geographical allocation of profit in Country S is limited to profit attributable to the PE.[14] If X co. does not have a PE in Country S, a leading case[15] of sales income is concerned with the title passage rule. However, the title passage rule is a proxy for finding the place of business and the proxy is not well-tuned. Roughly speaking, if X co. does not have a PE in Country S, we have an image that the geographical allocation and the personal attribution of the sales income is located in Country R.

II-1-6. Service income

Example (6) of service income is easy to think of like Example (5). If X co. has a PE in Country S, OECD Model Tax Convention, Article 7(1)'s second sentence is applied. X co. does not have a PE in Country S in a leading case,[16] a Mexican radio broadcasting enterprise's case. In this case, the Mexican enterprise got advertising income from American enterprises but it was ruled that the Mexican enterprise was not engaged in trade or business in the USA. (By the way, some tax lawyers might discuss that whether the Mexican enterprise had a PE in the USA or not. I think that this discussion has little meaning because even if the PE was found, the profit attributable to the PE would be small.[17]) Roughly speaking, if X

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[14] OECD Model Tax Convention, Article 7(1) second sentence and also, paragraph (2).

[15] *U.S. v. Balanovski*, 236 F.2d 298 (2nd Cir. 1956); reversing 131 F.Supp. 898 (1955).

[16] *Commissioner v. Piedras Negras Broadcasting Co.*,127 F.2d 260 (5th Cir. 1942), affirming 43 BTA 297 (1941).

co. does not have a PE in Country S, we have an image that the geographical allocation and the personal attribution of the service income is located in Country R.

II-1-7. The standard of place of payer ≠ the standard of place of demand

In Examples (1) (2) (3) and (4), it is not impossible to explain that the geographical allocation of rental income, dividends income, interest income and royalty income is decided by the standard of place of demand.

However, in Examples (5) and (6) of business income, the standard of place of demand is hard to apply. This article tries to find a more compatible explanation about images of the geographical allocation of several types of income (although impossible concerning Example (4)), and therefore, the standard of place of demand is denied.

If, in Example (1), the geographical allocation of rental income can be explained by the standard of place of earners' business, and if, in Examples (2) (3), the geographical allocation of dividends income and interest income can be explained by the standard of place of payers' business, we can rely on the standard of place of business (although incompatibility exists between earners' business and payers' business) concerning Examples (1) (2) (3) (5) and (6).

In Examples (2) and (3), if we do not look at X co.'s business profit (net income) but at dividends or interest payment by Y co. to X co. (gross income) and if we think that X co. only does financial transactions and payments of dividends or interest income are parts of the value added produced by Y co.'s real economic activities (that is, operations of real production factors such as humans, machines, or factories), Examples (1) (2) (3) (5) and (6) can be compatibly explained that the geographical allocation of income has been imaged looking at the place of real economic activities producing value added. This article tries to sublate (*aufheben*) the standard of place of earners' business in Examples (1) (5) and (6) and the standard of place of payers' business in Examples (2) and (3) as the standard of place of production.

II-1-8. Rethinking about royalty income: protection by governments is not easy to explain the geographical allocation

In Examples (1) (2) (3) (5) and (6), we can explain the geographical allocation of income according to the standard of place of production; on the other hand, is an image of the geographical allocation of the royalty income in Example (4) incompatible?

In Example (4), some tax lawyers might think that because Country S' government gives protection in intellectual property law (patent law, copyright law, or etc.), the geographical allocation of the royalty income should be considered to be located in Country S, and that it is not persuasive that the standard of place of production is compatible in Examples (1) (2) (3) (5) and (6) and is also suitable in Example (4). However, this article argues that protec-

[17] See, 岡直樹「『新課税権』『ミニマム税』提案の含意と国際租税法の展望」国際取引法学会学会誌5号（2020.3）(OKA, Naoki, "Implications of 'new taxing rights' and 'minimum tax' propositions and prospects for international tax law", The Japanese Association of International Business Law Academic Journal, no. 5, pp. 61-86 (2020)).

tion by governments is not a reason, because, in Examples (5) and (6), the geographical allocation of business income is considered to be located in Country R even though X co. gets business income with help of Country S' legal system.

In order to explain that the geographical allocation of the royalty income in Example (4) is located in Country S in compatible way with images that the geographical allocation of the business income in Examples (5) and (6), it can be possible to explain that X co.'s benefit derived from the legal system in Country S is different between Example (4) and Examples (5) and (6). However, this article argues that this explanation is not persuasive. Even if Country S does not have intellectual property law such as patent law or copyright law, it is not certain that X co.'s invention or creation is free to utilize in Country S. For example, Japan has a precedent case in which B co.'s imitation of wood grain papers constitutes illegal act against A co. and B co. must pay damages to A co. (Civil Code, Article 709),[18] even though A co.'s wood grain papers are not protected by copyright law.[19] Even though the wood grain papers are not protected by copyright law, we think that the wood grain papers are intellectual properties of A co. It is not impossible to explain that the intellectual property law's protection and its extent in Country S give a line-drawing concerning the geographical allocation of income in Example (4) and in Examples (5) and (6) because legal protection in Example (4) is stronger than in Examples (5) and (6), but I argue that this explanation is not compatible with Examples (2) and (3) because we find little difference of strongness of legal protection between Examples (5) and (6) and Examples (2) and (3).

If the intellectual property law's protection and its extent in Country S give a line-drawing concerning the geographical allocation of income in Example (4) and in Examples (5) and (6), why does the legal system protecting the dividend income and the interest income in Examples (2) and (3) justify images that the geographical allocation of income of the dividend income and the interest income is located in Country S? If intellectual property law's protection is special, the geographical allocation in Country S in Examples (2) and (3) would be denied. It is not impossible to explain that protection by Country S' government justifies images that the geographical allocation of income is located in Country S in Examples (2) (3) and (4) and does not justify in Examples (5) and (6); however, this explanation is not an explanation but a conclusion.

When trying to make compatible explanations about images of the geographical allocation of income, I argue that it is persuasive to explain that the standard of place of production has been adopted even though this explanation is not compatible in Example (4), because the incompatibility is small.

In my view, the standard of place of protection by governments is not good explanation. If the protection by government justify taxing rights, such tax would be based on compensation theory. Compensation is discussed in the context of efficiency. In the light of efficiency, Country S can impose tax not exceeding the extent of benefit of protection by Country S'

[18] Today, the damages have legal base in Unfair Competition Prevention Act.
[19] Wood grain paper case, Tokyo High Court, 1991 December 17th, reported in *Hanrei Jihô*, no. 1418, p. 120.

government. However, income tax is not only discussed in the context of efficiency but also in the context of equity or distributive justice, because income tax has the intent of redistributing income.[20] In order to reduce the income gap, the government must impose tax exceeding the extent of benefit of protection by the government.

II-1-9. Choice between the standard of place of demand or the standard of place of production is not decided with logic

As I said repeatedly, the geographical allocation of income is not decided by logic, and is only an image which tax lawyers have had historically. Therefore, the explanation that the standard of place of production can be compatible with more types of income than other standards only belongs to a *sein* discussion (a discussion about how it is), not a *sollen* discussion (a discussion about how it should be).

Source of income of {from what} is value added.[21] Value added is only a calculation of revenue minus purchase. The geographical allocation of value added also should be discussed as well as the geographical allocation of income. If we go to the next step, that is, a *sollen* discussion, possible alternatives are the place of demand or the place of production.

In a *sein* discussion, traditionally the geographical allocation of income has been according to the standard of place of production; this *sein* discussion does not necessarily give a base of disadvantage of the standard of place of demand in a *sollen* discussion. Since the end of the 20th century,[22] academic tax scholars started to discuss about the standard of place of demand in the light of electronic commerce[23] (although incompatible with the traditional geographical allocation of income in the context of a *sein* discussion), and such discussion is not strange in a *sollen* discussion. It is because there is no logical answer whether source of income of {from what} is production or demand.

In the 21st century, the wording of {value creation} is replaced with the traditional wording of source of income. Source of income (geographical allocation of income) is traditionally imaged by the standard of place of production; it might be guessed that the wording of value creation produces (is chosen in order to produce) a space in which we can play of tug-of-war about taxing rights allocation in the 21st century between the standard of place of production and the standard of place of demand.

II-2. Choice since the era of the League of Nations: (1) no taxation without a PE (2) separate accounting (3) attributed income principle

When Country S tries to impose tax on business income of a foreign enterprise (X co.)

[20] Some lawyers hate to use the word {redistribution} but this article does not address distribution and redistribution. See, Liam Murphy & Thomas Nagel, "The Myth Of Ownership: Taxes and Justice" (Oxford University Press, 2002).
[21] In this article, I do not address the global income concept and consumption-type concept of income (footnote 3), and do not address income-type of value added and consumption-type of value added.
[22] See, Unknown, "Disappearing Taxes", The Economist, 1997 May 31st, p. 19.
[23] See, Richard L. Doernberg, "Electronic Commerce and International Tax Sharing", 16 Tax Notes International 1013-1022 (1998 March 30); Richard L. Doernberg & Luc Hinnekens, Electronic Commerce and International Taxation (Kluwer, 1999).

(ignoring withholding tax on capital income), there are three keys. The first is threshold. The second is income allocation between a domestic entity and foreign entities. The third is the scope of income which is subject to tax filing system. About these three keys, the left sides are the traditional choice since the era of the League of Nations to the OECD Model Tax Convention and right sides are alternatives.

(1) <Threshold>
No taxation without a PE vs. No taxation without a PE or an affiliated entity
(2) <Income allocation>
Separate accounting + arm's length principle vs. consolidation + formulary apportionment
(3) <Scope of income filed>
Attributed income principle vs. entire income principle (force of attraction)

Traditionally, limitation on tax on a foreign enterprise looks at (1) threshold at first, that is {no taxation without a PE} rule (subsection II-2-2 will explain {no taxation without a PE or an affiliated entity} rule). In negotiation between Country R and Country S when entering into a tax treaty, the width of the definition of a PE is easy to negotiate (OECD and UN Model Tax Convention, Article 5). On the other hand, concerning (2) income allocation, OECD member countries have had a consensus that the arm's length principle is used generally and formulary apportionment can be used only exceptionally (nonmember countries might be reluctant to agree with this consensus but they also know the consensus).

However, in this article, I argue that the most epoch-making choice in the era of the League of Nations when the backbone of the existing international tax law system was shaped is (2) income allocation; at that time, the idea of separate accounting was adopted. The wording of {epoch-making choice} has two meanings; the first is that the choice has affected international tax law system broadly; the second is that the choice was not an {unavoidable choice} at that time in the light of limitation of enforcement capacity in Country S.

But, first, (1) threshold is discussed.

II-2-1. (1) Threshold (no taxation without a PE)

In the light of limitation of enforcement capacity in the first half of the 20th century (without international exchange of information as in the 21st century), when Country S tries to impose tax on business income of a foreign enterprise (X co.), Country S cannot easily reach its taxing arms to X co. without X co.'s physical presence in Country S; therefore, choice of {no taxation without a PE} rule was, if not unavoidable (because withholding tax not only on capital income but also on business income is not impossible), a nearly unavoidable choice. The OECD Model Tax Convention adopted a threshold of PE concept and American domestic tax law historically adopted a threshold of {trade or business in the USA} concept; some tax lawyers might think that PE concept was not unavoidable choice. However, there is little difference between the PE concept and the {trade or business in the

USA} concept. When a foreign enterprise has no physical presence in the USA, {trade or business in the USA} threshold is hardly accomplished. Regardless whether OECD Model or American domestic law (or other countries' domestic law), some physical presence of a foreign enterprise is required. Japanese domestic tax law adopted an exception of {no taxation without a PE} rule concerning personal service income, in which service income of a foreign resident can be taxed in Japan even if he/she has no PE in Japan; however, this rule requires real performance of services in Japan and it also can be explained that physical presence of his/her body is required to justify Japanese taxing right.[24] In the context of VAT (value added tax), discussion about taxation on a foreign enterprise without physical presence started at the end of the 20th century, but, regardless whether in the context of VAT or income taxation, physical presence was required in order to enforce taxing power against a foreign enterprise until the end of the 20th century.

Nowadays, a service PE concept[25] is discussed, but Japanese domestic tax law's imposition of tax on personal service income without an establishment functionally resembles a service PE taxation. Taxation on entertainers and sportspersons by OECD Model Tax Convention, Article 17 was categorized as an exception of the PE concept in the 20th century, but in the 21st century, Article 17 can be categorized as one example of the service PE concept. If we do not care about what we call {service PE}, {personal service income taxation without a PE in Japan}, or {OECD Model, Article 17}, it can be said that the key of {no taxation without a PE} rule requires a domestic physical presence of a foreign enterprise, not the definition of the PE concept.

And moreover, I said {withholding tax not only on capital income but also on business income is not impossible}, and in reality, UN Model Tax Convention, Article 12(2) or other domestic tax laws impose withholding tax on royalty income. It can be said that the key is what types of income can be categorized as UN Model, Article 12(2). India is famous (infamous?) about this kind of withholding tax on fees for technical services, but India is not an exception. Japan also tried to widen objects of withholding tax in the 20th century (see, footnote 12).

In summary, concerning (1) threshold in the light of limitation of enforcement capacity in first half of the 20th century, Country S must have relied on withholding tax or domestic physical presence when trying to impose tax on a foreign enterprise; that is, nearly unavoidable choice. However, as discussed later in subsection II-2-2, {relying on domestic physical presence} does not necessarily mean the {no taxation without a PE} rule. The {no taxation without a PE} rule is a subcategory of {relying on domestic physical presence} and there can be another subcategory, that is {no taxation without a PE or an affiliated entity} rule.

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[24] About Income Tax Act, Article 164(1)(iv), see ASATSUMA, Akiyuki, "Japan", in IFA 2012 Boston Congress: cahiers de droit fiscal international, volume 97a, Enterprise services, pp. 413-435 (2012).

[25] This article does not address (old) OECD Model Tax Convention, Article 14's "fixed base" concept because the fixed base concept resembles the PE concept.

II-2-2. If, concerning (2) income allocation, we do not adopt separate accounting, is there an alternative concerning (1) threshold?

Concerning (2) income allocation, the League of Nations (especially, Carrol) adopted the idea of separate accounting, as explained by FUCHI, Keigo or other tax law scholars.[26]

This article does not assess history. In order to look at functions of international tax law system, this article thinks a space in which the international tax law system could have adopted an idea other than separate accounting concerning (2) income allocation.

A counter part of separate accounting is consolidation. In the international tax law system, separate accounting fits well with the arm's length principle and consolidation fits well with formulary apportionment. Therefore, traditionally international tax law discussions mainly look at the choice between the arm's length principle vs. formulary apportionment rather than separate accounting vs. consolidation. {Vs.} sounds like equal chance of the arm's length principle and formulary apportionment, but, actually, the arm's length principle is considered general and formulary apportionment is considered an exception.

If we do not adhere to separate accounting, what kind of international tax law system could have been evolved?

Regardless whether we adopted separate accounting or not, we have little room concerning (1) threshold issue; we must rely on withholding tax or rely on domestic physical presence in first half of the 20th century. Concerning {relying on domestic physical presence}, tax lawyers have long discussed the width of the PE concept. However, if we do not adhere to separate accounting, the widening of the PE concept is not only one way that Country S can lengthen its taxing arms to a foreign enterprise. Another way is {no taxation without a PE or an affiliated entity} rule.

Let's see Examples (1) – (6) in section II-1. Country R's X co. has entered into Country S in some economic sense and we discuss whether Country S can impose tax on Country R's X co. or not. I confirmed that demand itself in Country S is hardly a base of the geographical allocation of income in Country S, although an exception is Example (4) with royalty income. The width of the PE concept looks at the extent of presence of X co.'s direct alter ego in Country S. However, in real international transactions, physical presence in Country S is not only X co.'s direct alter ego (typically, a branch), but also X co.'s indirect affiliated entity. If we adhere to separate accounting, X co.'s affiliated co. established in Country S is not a PE of X co. in Example (b) (see below), and a branch in Country S of X co.'s affiliated co. not established in Country S is not a PE of X co. in Example (c). In Examples (b) and (c), the physical presence in Country S has a possibility to become an agent PE of X co., but even if an agent PE is recognized, profits attributable to the PE would be very small (profits attributable to an agent PE is discussed also in subsection III-2-2).[27] If we do not adhere to the idea of separate accounting, Country S' domestic physical presence not only in Example (a) but also in Examples (b) and (c) can be help for enforcement of Country S' tax on X co.

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[26] See, 渕圭吾『所得課税の国際的側面』（有斐閣，2016）(FUCHI, Keigo, "INTERNATIONAL ASPECTS OF INCOME TAXATION" Yûhikaku, 2016).

It can be said that not only a direct PE of X co. in Example (a) but also an indirect affiliated entity of X co. in Examples (b) and (c) are the threshold; we can call the rule the {no taxation without a PE or an affiliated entity} rule rather than the {no taxation without a PE} rule.

Country R Country S
(a) X co.-----------------------------branch
(b) X co.-----------------------------X co.'s affiliated co.
(c) X co.---X co.'s affiliated co.---The affiliated co.'s branch

Let's think reversely. Concerning (1) threshold in the light of limitation of enforcement capacity in first half of the 20th century, {relying on domestic physical presence} does not exclude the possibility to adopt {no taxation without a PE or an affiliated entity} rule; therefore, the reason that we did not adopt the {no without taxation without a PE or an affiliated entity} rule does not exist in the context of (1) threshold but in the context of (2) income allocation, in which, in real history, we adopted the idea of separate accounting. Logically, the {no taxation without a PE} rule in (1) threshold discussion is not the root of adopting separate accounting in (2) the income allocation rule, because the {no taxation without a PE} rule can be enforced with other income allocation rules than separate accounting (that is, formulary apportionment). Therefore, I argue that the choice in (2) income allocation was more epoch-making than the choice in (1) threshold.

The {no taxation without a PE or an affiliated entity} rule was not adopted in real history. However, we can find a similar attitude in an Italian case,[28] in which a German corporation was considered to have an agent PE with the existence of the affiliated corporation of the German corporation in Italy. If we care about the real history, a PE in Italy can be found by direct link between Italian physical presence and the German corporation; indirect link between Italian affiliated corporation and the German corporation is not a base to find a PE. At that time, Italian Corte Suprema Di Cassazione was blamed by international tax lawyers (also Italian lawyers). This case shows that if the idea of separate accounting was applied rightly, Italian taxing rights would be seriously restricted. The Italian court gave taxing power to Italy. And roughly ten years later, OECD discussed anti-BEPS measures and, in discussion of widening of PE concept, OECD adopted anti-fragmentation measures[29] which try to

[27] There has been discussion about calculation of profits attributable to an agent PE; single taxpayer approach and double taxpayer approach (or dual taxpayer approach). OECD has not officially adopted single taxpayer approach with fear for losing face. However, when we adhere to the arm's length principle, even if we assume double taxpayer approach, profits attributable to an agent PE is not much different than if we assume a single taxpayer approach. Many international tax lawyers who can speak without being constrained by their position think that the double taxpayer approach is near death. Even if the double taxpayer approach has meanings, Country S' tax base would barely be substantially increased.

[28] *Ministry of Finance (Tax Office) v. Philip Morris GmbH*, Corte Suprema Di Cassazione (Sezione Tributaria), Rome, Judgment date: 2002 March 7th, reported in 4 International Tax Law Reports 903-946 (2002) (concerning VAT, 947-1008).

[29] See, OECD/G20, "Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report" (2015 October 5 https://doi.org/10.1787/9789264241220-en) p. 39, "Fragmentation of activities between closely related parties". Also see, p. 42, "Splitting-up contracts".

find a PE with a lack of respect with the historical adherence to a direct link between domestic physical presence and a foreign enterprise even when a foreign enterprise tries to segmentalize activities in order to avoid a PE recognition. I understand that international tax lawyers now withdraw the blame against the Italian court.

II-2-3. Choice in the era of the League of Nations: the idea of labor value theory?

Subsection II-2-1 discussed that concerning (1) threshold, withholding tax or relying domestic physical presence are affordable way in the era of the first half of the 20th century.

Choice in the era of the League of Nations was that concerning income (dividends, interest, royalty, or etc.) subject to withholding tax, geographical allocation was given more respect than personal attribution (although I argue that the geographical allocation of royalty income is not compatible with other types of income in subsection II-1-4).

On the other hand, the {no taxation without a PE} rule and the attributed income principle (OECD Model, Article 7(1) first and second sentences) put more respect on personal attribution than geographical allocation. PE taxation is a matter of Country S' source tax jurisdiction, but weakens the idea of geographical allocation.

If we do not adhere to separate accounting in the context of (2) income allocation, the {no taxation without a PE or an affiliated entity} rule concerning (1) threshold can be adopted even in the light of limitation of enforcement capacity in the first half of the 20th century, and in the context of (3) scope of income subject to filing not subject to withholding taxation, the attributed income principle is not necessary and the entire income principle (adopted before the 1966 amendment in the USA and before the 2014 amendment in Japan) with the force of attraction rule would be subject to less objection than in real history.

Even though it is possible to adopt the entire income principle if we do not adhere to separate accounting, the geographical allocation of business income might be adhered to the standard of place of production (see subsection II-1-9) and even the entire income principle cannot substantially increase the tax base in Country S (ignoring dividends income, interest income, royalty income, or etc. which are subject to withholding tax). On the other hand, if the standard of place of demand is applied concerning the geographical allocation of business income, the entire income principle can substantially increase the tax base in Country S.

I argue that adopting separate accounting was an epoch-making choice (see subsection II-2-2), but a choice between the standard of place of production and the standard of place of demand concerning geographical allocation of income also has affected the international tax law system broadly.

The standard of place of production might have seemed to be more natural than the standard of place of demand because income taxation is taxation on income earners in the first half of the 20th century. Therefore, I do not call the choice of the standard of place of production as an epoch-making choice. However, the broadness of impacts from the choice between the standard of place of production and the standard of place of demand might be as large as the choice of adopting separate accounting.

Why did we adopt the standard of place of production rather than the standard of place of demand and why did we place more respect on personal attribution of income rather than geographical allocation of income? I do not have enough evidence but I guess that the international tax law system since the era of the League of Nations has been based on labor theory of value (note that this sentence belongs to a *sein* discussion, not a *sollen* discussion).[30] Original labor theory of value looks at conflicts between laborers and capitalists who have machines or other real production factors other than human capital; but this article's attention to labor theory of value explains that source of income in the meaning of {from what} is an operation of real production factors (humans, machines, factories, or etc.) and draws no line between humans and machines, factories, or etc. Labor theory of value will explain that source of income of {from where} is determined the location of source of income of {from what}, which means real production factors.

If labor theory of value has been the thoroughbass (*basso continuo*) of international tax law system since the era of the League of Nations, it is natural that discussions about the arm's length principle in the 21st century have tendency to look at contribution of human capital and tendency to disrespect unreal contribution from a so-called cash box corporation. And more, GILTI in American domestic law also respects operations of real production factors and is compatible with labor theory of value.

III. Mild and severe derogation from the arm's length principle

III-1. Reliable and unreliable arm's length transactions

The choices since the era of the League of Nations are, concerning (1) threshold, {no taxation without a PE} rule, concerning (2) income allocation, separate accounting, and concerning (3) scope of income subject to filing, and attributed income principle; however, in some cases, a real arm's length transaction which is treated as a comparable transaction in a transfer pricing case has a possibility to lead to absurd results even if we believe in the arm's length principle.

III-1-1. Compensation for non-action: *Korfund* case

A leading case[31] about compensation for non-action treats source of income derived from a covenant not to compete. In this case, a German corporation, Zorn co. had been obligated not to compete in North America and received payments from American corporation, Korfund co.

Zorn co. and Korfund co. were not unaffiliated enterprises, but they fought the amount of the compensation not to compete seriously. Therefore, we can say that the amount was

[30] In my narrow search, Itai Grinberg, "International Taxation in an Era of Digital Disruption: Analyzing the Current Debate", Taxes (2019 March) pp. 85-118, at 89 is the first article which refers to Karl Marx. Also see, Itai Grinberg, Stabilizing 'Pillar One': Corporate Profit Reallocation in an Uncertain Environment (unpublished, 2019 July 26 https://ssrn.com/abstract=3429863). I have said Karl Marx orally, but I did not have the bravery to write Karl Marx in my old articles.

[31] *Korfund v. Commissioner*, 1 T.C. 1180 (1943). Although the issue was the source of income and the result was that the source of income existed in the USA, this article looks at deductibility of the payment, which was not the issue in the real case.

not artificial, and met arm's length price. And next, let's suppose that the same amount is paid from an American corporation (Y co. in Country S) to a German corporation (X co. in Country R) who are affiliated enterprises in an abstract example and let's think about the arm's length principle.

If Country R's X co. is obliged not to compete in Country S and gets compensation for the obligation paid from Country S' Y co. and the terms and the amount of the payment are same as in the *Korfund* case, does Country S allow Y co. to deduct the payment (of course, the amount meets arm's length price)?

Most international tax lawyers would answer that such deduction should not be allowed. It means that deduction can be denied even if the amount meets arm's length price. Therefore, we, international tax lawyers, cannot ignore the existence of unreliable arm's length transactions[32] in determining personal attribution of income in a transfer pricing case.

I wonder whether existing law has grounds to deny deduction of payment of the compensation of legal obligations not to compete even when the terms and the amount are same as in the *Korfund* case. If labor theory of value has been the thoroughbass of the existing international tax law system, the payment from Korfund co. to Zorn co. was labor value of Korfund co. Even if the payment from X co. to Y co. is same as in the *Korfund* case, the deduction of the payment should be denied when X co. and Y co. are affiliated. However, I wonder whether existing law has grounds, with the idea of labor theory of value, to deny deduction of the payment.

In this regard, the value creation concept is used in the 21st century, and it is possible to explain that Zorn co. in the real case or X co. in an abstract example has no contribution to value creation. I argue that we, international tax lawyers, should recognize that there is difference between value creation and the arm's length principle.[33] However, even though it might be possible to deny deduction of the payment of Y co. in a case between affiliated enterprises because X co. has no contribution to value creation, it would be more difficult to deny deduction of the payment of Korfund co. because Korfund co. and Zorn co. were in a serious dispute and the amount was not artificial even though they were not unaffiliated. Therefore, I stress the difference between personal attribution of income and geographical allocation of income.

In the context of the original labor theory of value, capitalists who have machines, factories or other factors other than human capital and laborers who have only human capital are in conflict; if the idea of non-permission of exploitation of value by capitalists is applied in international tax law, income allocation between Country S' physical presence and a foreign

[32] In *Xilinx v. Commissioner*, 125 T.C. 37 (2005); 598 F.3d 1191 (9th Cir., 2010 March 22) and *Altera v. Commissioner*, 145 T.C. No. 3 (145 T.C. 91, 2015 July 27), we can say that although taxpayers rely on unreliable arm's length transactions, courts allow the income allocations according to the arguments of taxpayers. But, in my view, the statement that courts deserve condemnation is not accurate. It is more accurate to say that defectiveness of tax treaties and domestic law overlooked scopes of unreliable arm's length transactions. Note that *Altera* case is reversed. 9th Circuit, Nos. 16-740496, 16-70497, Tax Ct. Nos. 6253-12, 9963-12 (2019 November 12) (http://cdn.ca9.uscourts.gov/datastore/opinions/2019/11/12/16-70496.pdf).

[33] See, 浅妻章如「BEPS: value creationとarm's lengthとの異同，次にvalue creation 基準の難点」税大ジャーナル27号35頁（2017.3）(Asatsuma, Akiyuki, "BEPS: difference between value creation and the arm's length and difficulties of the value creation standard", Zeidai Journal, no. 27, pp. 35-48 (2017 March)).

enterprise should be calculated in a way that the physical presence (if a PE, be personalized) is 100% capitalized, owes zero debt, and paid dividends cannot be deducted from the tax base of the physical presence.[34] And moreover, reliable arm's length comparables would be assumed in a way that income is calculated with 100% capitalization and zero debt and with owing standardized risk (see subsection III-1-2).

III-1-2. *Adobe* transfer pricing case

In the *Adobe* transfer pricing case,[35] the taxpayer argued that an Irish corporation had large functions and risk and a Japanese corporation had small functions and risk and therefore income attributable to the Japanese corporation is low. The court ruled for the taxpayer. Transfers of functions and risk are legal in private law. If tax law does not differentiate between reliable and unreliable arm's length transactions, it is difficult to blame the result in the *Adobe* case.

It is said that arm's length price is determined with respect of functions, assets, and risk. However, if transfer of income according to transfer of risk is allowed, unreliable arm's length principle gets mixed in. If it is possible to say that appropriate income allocation traditionally reflects the idea of labor theory of value (geographical allocation of income is considered to be located in a place of operations of real production factors such as humans, machines, factories, or etc.), we should clearly legislate that risk allocation between (or among) affiliated enterprises be denied even if such risk allocation is *bona fide* in private law.

However, legislative discussion denying risk allocation has not been developed enough other than in the context of so-called cash box corporations. Once the OECD said that arm's length price is determined with respect of functions, assets, and risk; therefore, the OECD might now hesitate to openly say denying risk allocation.

And more, difficulties about denial of risk allocation are also concerned with the problem that we can hardly show standard risk allocation in order to deny abnormal risk allocation as in the *Adobe* case. We rely on standard transactions in the past at best, but we can hardly show the line between standard and abnormal risk allocation in rise of new transactions.

Now, there is consensus among international tax lawyers that contribution of bearing risk by a so-called cash box corporation (or a fat capitalization) should be denied (partly approved to the extent of rate of return for portfolio investors); however, it is a continued challenge of how we can deny arbitrary contribution of bearing risk by a corporation which is not a cash box corporation or whether we should deny it or not. Subsection III-1-3 will discuss a cash box corporation.

There is another issue: in the *Adobe* transfer pricing case, although the result of legal interpretation at that time was right in *de lege lata*, in *de lege ferenda*, the strangeness is not

[34] As I say below (chapter IV), I think that corporation tax system should adopt the expensing method or cash flow taxation; therefore, I am not persuaded by the idea of Marx economics in a *sollen* discussion.
[35] Tokyo High Court, 2008 October 30th, reported in *Zeimu Soshô Shiryô*, no. 258-11061.

only the extent of arbitrary bearing risk being with an Irish corporation but also the choice of arm's length comparables when it was not known who would become the winner although the *Adobe* group corporations had already known who was the winner. Subsection III-3-1 tries to make a model.

III-1-3. What American tax base is eroded in Google's Double Irish?

In Google's tax planning (so-called Double Irish & Dutch Sandwich, although this article ignores Dutch Sandwich), an Irish corporation, X co. who is a cash box corporation supplies money to Y co. who employs researchers and does R&D (research and development) in the USA (therefore, Ireland is Country R and the USA is Country S. In the real case, there are two Irish corporations but the number is not important in this article).[36]

If X co. contributes money to Y co., then Y co. pays dividends income to X co. (see, subsection II-1-2); the payment of the dividends is not deductible from the tax base of Y co. generally and the geographical allocation of the dividends income is considered to be located in Country S.

If X co. lends money to Y co., then Y co. pays interest income to X co. (see, subsection II-1-3); the payment of interest income is deductible from the tax base of Y co. generally but the geographical allocation of the interest income is also considered to be located in Country S. Moreover, deduction of interest payment is subject to many anti-earnings stripping measures such as thin capitalization legislation or transfer pricing legislation.[37] And, there have been many discussions to minimize the difference between equity and debt; for example, CBIT (Comprehensive Business Income Tax) and ACE (Allowance for Corporate Equity).[38]

Google's tax planning is called buy-in, which nearly accomplishes the result of money contribution or lending with legal form of sell-buy transactions in private law.[39]

In transfer pricing discussion in the 21st century, X co.'s bearing risk and earning income correspondent with the risk is denied and only income correspondent with the rate of return of portfolio investors is attributable to X co. However, I regret that the transfer pricing discussion, only looking at personal attribution of income, lacks a view point of geographical allocation of income. In the light of geographical allocation of income, income attributable to X co., even if restricted to the portion of the rate of return of portfolio inverstors, should be considered as located in Country S if we care about consistency with geographical allocation of dividends income and interest income.

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[36] See，浅妻章如「Google等の租税回避の対抗策における移転価格以外の課題」小泉直樹＝田村善之編『中山信弘先生古稀記念論文集　はばたき―21世紀の知的財産法』1025頁（弘文堂，2015）(ASATSUMA, Akiyuki, "Anti-tax planning of Google or other enterprises and a challenge other than transfer pricing issue", in KOIZUMI, Naoki and TAMURA, Yoshiyuki, ed., IN HONOR OF 70TH BIRTHDAY OF PROFESSOR NAKAYAMA, NOBUHIRO: *HABATAKI* (FLAPPER) – INTELLECTUAL PROPERTY LAW IN 21st CENTURY, p. 1025, Kôbundô, 2015).

[37] See, OECD/G20, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update" (2016 December 22 https://doi.org/10.1787/23132612).

[38] Institute for Fiscal Studies, MIRRLEES REVIEW: TAX BY DESIGN (Oxford University Press, 2011), Chapter 17: "Taxing Corporate Income"; Kôyama, footnote 13.

[39] As said in footnote 13, there have already been transactions whose nature is difficult to characterize whether financial transactions or real economic transactions; therefore, it might be too much to say that Google's tax planning is breakthrough.

Subsection III-1-1 reveals existence of unreliable arm's length transactions.

Subsection III-1-2 reveals that, in the context of application of the arm's length principle for transactions between affiliated enterprises, if we fail to legislate to deny arbitrary bearing of risk which is legal in a private law sense, income allocation can be derogated from income allocation which has been traditionally approved among international tax lawyers (that is, income allocation correspondent with the idea of the labor theory of value).

Subsection III-1-3 reveals that the arm's length principle treats only personal attribution of income, and has little appropriateness in the context of geographical allocation of income.

III-2. First level: mild derogation from the arm's length principle with the standard of place of production

Section III-1 reveals that, even though we should comply with the arm's length principle in a general sense, because the existence of unreliable arm's length transactions is clear, we need to legislate to allow tax authorities to exceptionally derogate from the arm's length principle in order to restrict arbitrary income shifting in the light of geographical allocation of income. Now, international tax lawyers have already started to discuss allocation of taxing rights correspondent with demand, but this discussion is severe derogation from the arm's length principle which has been the tradition of the international tax law system since the era of the League of Nations. Let's start from mild derogation from the arm's length principle with adherence to the standard of place of production which has also been the tradition of the international tax law system.

III-2-1. Profit sharing between Country S' residents and Country R's residents: *Nihon Guidant* case

Let's assume that Country R's lawyer X and Country S' lawyer Y enter into an agreement to make a partnership in order to share income for risk sharing. In a certain year, X can do nothing because of illness and Y's earnings are split between X and Y. Therefore, Y pays half of Y's earnings to X.

In the situation of a partnership arrangement, X is considered to have a PE in Country S in Japan, the USA or European countries.

It can be explained that X has his/her disposition of Y's office in Country S (in Japan, 合有 (*gôyû*: translated from German words, *Eigentum zur gesamten Hand*: ownership of the entire hand) concept is a base for finding the right of disposition). However, it can be questioned: if X is prohibited to do activities in Country S clearly in the partnership arrangement, does X have the legal right of disposition in Country S? In this regard, tax authorities will dare to find a PE of X in Country S even though the legal logic of X's disposition in Country S is not clear. I doubt that the partnership arrangement is the reason that X has his/her disposition in Country S in the light of text of "through which the business of an enterprise is wholly or partly carried on" in OECD Model Tax Convention, Article 5(1), when X has no right to enter Country S. However, my doubt has not been discussed widely.

There are many legal forms in which profit is shifted from Country S' enterprise (including an individual as a lawyer) to Country R's enterprise through profit sharing arrangements. In a case[40] in Japan, 匿名組合 (*tokumei kumiai*, also known as TK: translated from German words, *stille Gesellschaft*: sleeping or silent partnership) was used for profit shifting from a Japanese corporation to a Dutch corporation. The court did not find a PE in Japan of the Dutch corporation. The result is strange in the light of geographical allocation of income. However the Japanese court kept its temper in interpretation of the text of a tax treaty. It is common in European countries including the Netherlands that a PE is found in Country S in profit sharing arrangements, regardless whether partnership form or *stille Gesellschaft* form (in *Nihon Guidant* case, the Dutch corporation had argued that it had a PE in Japan and the Dutch tax authority approved the argument although the Dutch corporation argued that it had no PE in Japan in a court case in Japan); but it seems to me that European countries have not interpreted the text of tax treaties in good faith. Also in the USA, a PE is easily found when an American enterprise has a partnership arrangement with a foreign enterprise and issue was whether a partnership arrangement could be found or not, not whether a PE could be found or not.[41]

European countries and the USA find PEs in profit sharing arrangements more easily than Japan. Such easiness can be justified in order to protect source tax jurisdiction. However, I argue that international tax lawyers should recognize in good faith that a profit sharing arrangement is a loophole of PE taxation in the light of the text of the definition of a PE. After *Nihon Guidant* case (footnote 40), Japan expressly introduced a special clause in the protocol of the Japan-Netherlands tax treaty in order to protect Japanese taxing rights without finding a PE but with withholding tax in *tokumei kumiai* arrangements. I argue that international tax lawyers other than Japan should follow the example of Japan in order to block the loophole in profit sharing arrangements.

Subsection III-2-1 explores a profit sharing case and subsection III-1-1 explores a case of compensation not to compete; they are loopholes of PE taxation and the arm's length principle if we interpret the text of tax treaties in good faith. We need to legislate in order to block the loopholes. We can propose several countermeasures: first, withholding tax in *tokumei kumiai* arrangements as in Japan; second, denying deduction of payment from tax base in Country S; third, a special PE concept. We do not need to limit countermeasures to one measure. First, we need to recognize loopholes of PE taxation and the arm's length principle as in subsections III-2-1 and III-1-1. If recognized, then international tax lawyers would be able to reach a consensus that profit shifting from Country S' residents to Country R's residents not correspondent with supply of goods or services shall be subject to source tax juris-

[40] *Nihon Guidant* case, Tokyo High Court, 2007 June 28th, reported in *Hanrei Jihô*, no. 1985, p. 23. Concerning European countries, see, Arvid Aage Skaar, "Permanent Establishment: Erosion of a Tax Treaty Principle" at 173 (Kluwer Law and Taxation Publishers, 1991).

[41] In *W. C. Johnston v. Commissioner*, 24 T.C. 920 (1955), a Canadian resident was subject to PE taxation in the USA. There was no discussion whether a partnership arrangement was a base to find a PE. I cannot find the reason why American tax lawyers had found a PE so easily in partnership arrangements. The issue was whether the Canadian resident and an American resident were in a partnership arrangement or not.

diction, more easily than taxing rights allocation correspondent with demand as discussed in section III-3.

III-2-2. Profit attributable to an agent PE: how to give a reason to double taxpayer approach in good faith

If we do not expressly legislate derogation from the arm's length principle, it is difficult, if not impossible, to protect the double taxpayer approach (dual taxpayer approach) concerning profit attributable to an agent PE and single taxpayer approach is easier.

I argue that if the double taxpayer approach is located as derogation from the arm's length principle, it might enhance the persuasiveness of the double taxpayer approach. If there is a situation where a double taxpayer approach leads to a different result than a single taxpayer approach, such a situation would be concerned with income allocation of synergy effects between an agent PE in Country S (Y co.) and a principal in Country R (X co.). If synergy effects which cannot be aroused between real arm's length transactions exist, it is not easy to deny income attribution to X co. when X co. has negotiation power against Y co. if we do not expressly legislate derogation from the arm's length principle. On the other hand, if we expressly legislate derogation from the arm's length principle and if we recognize the difference between geographical allocation of income and personal attribution of income, then, because geographical allocation of income has no logical base from the start, we can say in good faith that we will make consensus concerning allocation of synergy effects in the future.

A single taxpayer approach is said to be disadvantageous to source tax jurisdiction and this fear is the same as profit sharing in subsection III-2-1, in my view. In subsection III-1-1 concerning compensation not to compete, Korfund co.'s business profit became large because Zorn co. did not compete in the USA, and therefore, the compensation not to compete can be easily considered as geographically located in the USA, even though the compensation not to compete is paid in accordance with arm's length price. As well as in subsection III-1-1, subsections III-2-1 (profit sharing) and III-2-2 (profit attributable to an agent PE when synergy effects can be found) are good examples that income geographically allocated in Country S can be attributable to Country R's resident if we do not expressly legislate derogation from the arm's length principle. Express legislation of derogation from the arm's length principle in order to make consensus for protecting source tax jurisdiction concerning income which is considered as geographically allocated in Country S is not easy in the context of political negotiation, but is an honest discussion in the light of the traditional thoroughbass of the international tax law system, that is, labor theory of value.

Subsections III-2-2 concerning synergy effect and III-1-1 concerning large profit because of covenants not to compete are examples that PE taxation (the {no taxation without a PE} rule and the {tax on only profit attributable to the PE} rule) and the arm's length principle make loopholes for protecting source tax jurisdiction. Recognition of loopholes and blocking the loopholes is not an outlandish story.

III-2-3. Is there reason that royalty payment of intellectual properties is partly transferred out of the fruits of business of the payer?

In subsection II-1-4, it is assumed that royalty payment from Y co. in Country S to X co. in Country R is correspondent with X co.'s real economic activities (operations of real production factors such as humans, machines, factories, or etc.) in Country R, that is, invention. In this subsection, this assumption is relaxed.

International tax lawyers have a tendency to assume income allocation among affiliated enterprises (including branches) according to physical contributions which have been made by each person or part. If the labor theory of value has been the thoroughbass in the traditional international tax law system, income allocation correspondent with contributions is understandable. However, income allocation between real arm's length parties is not necessarily correspondent with contribution; a person who has done no contribution can earn income (see, subsections III-1-1 and III-2-1).

Let's suppose that X co. in Country R and Y co. in Country S are affiliated enterprises (including the situation in which Y has no legal personality), that X co. has created inventions in Country R and gets patent rights in Country S and Y co. does business activities of producing and sales of goods with license of the patent right in Country S for the inventions. International tax lawyers make a fiction in which Y co. pays arm's length royalty income to X co. (if Y is a branch of X co., then there is no written contract to pay royalty income but, in order to calculate profit attributable to the PE, royalty payment from Y to X co. is deemed). International tax lawyers also have a tendency to assume that Y co. should earn income according to the physical contribution of Y co.'s production and sales activities.

Country R   Country S
(a) X co.----------------------------Y co. (affiliated parties)
(b) Z co.----------------------------W co. (arm's length parties)

Next, suppose that Z co. in Country R and W co. in Country S are arm's length parties, that Z co. has created inventions in Country R and gets patent rights in Country S, that W co. infringes on the patent rights and does business activities of producing and sales of goods in Country S concerning the inventions, that Z co. requires damages to W co., and that Z co. has had a plan to establish an affiliated entity (branch, subsidiary, sister company, or etc.) who would do business activities of producing and sales of goods in Country S and has had no plan to make a license agreement with Country S' arm's length party. In the light of entitlement of the patent rights, Z co. could have enjoined W co. from producing and selling such goods. Income allocation according to the physical contribution of W co.'s activities, which means that damages payments from W co. to Z co. should be reduced in respect of income according to W co.'s contribution, has no legal base in the light of the entitlement above in a private law sense. International tax lawyers admire income allocation according to contribution of real economic activities but such income allocation is not based on intellectual property law from the view point of private lawyers.

Let’s suppose concrete figures in order to have an image.

X co. invests 2000 to invention activities. Y co. invests 3000 to production and sales activities. If X co. and Y co. prospect 10% return (if X or Y has prospection with higher return than Y or X, Y or X should increase investment amount from the view point of finance) and the prospection has come true (although prospection in business activities is not ensured in real world), total revenue of Y co. before royalty payment is 5500 (profit is 500), and 3300 (profit is 300) should be attributable to Y co. and 2200 (profit is 200) should be attributable to X co. (therefore, a fiction is made that Y co. pays royalty income of 2200 to X co.). Income allocation according to contribution of real economic activities among affiliated parties is common among international tax lawyers.

On the other hand in arm’s length settings, let’ suppose that Z co. invests 2000 to invention activities, that Z co. has had a plan to establish an affiliated entity in Country S who would invest 3000 to production and sales activities, that Z co. in Country R and the affiliated entity in Country S would prospect 10% return, that W co. infringes the patent right in Country S before the affiliated entity of X co. in Country S is established and the investment of 3000 has not happened in Country S, and that W co. must pay damages to Z co. What amount is the damages? Because Z co. has had a plan to earn profit of 500, therefore, the entitlement of the patent law will give power to Z co. to earn the damages of 2500. Private lawyers think that contribution of real economic activities done by W co. in Country S provides no legal base for income to W co. If the amount of the damages is presupposed, then next, let’s suppose that W co. tries to make a license agreement with X co. before establishment of the affiliated entity in Country S. Z co. has had a plan to earn profit of 500, therefore, Z co. will require royalty payment of 2500 from W co. From the view point of international tax lawyers, 300 out of 2500 might be considered to be the fruits of real economic activities of W co., but private lawyers do not think so in arm’s length settings.

Arm’s length royalty payment from W co. to Z co. might be higher than fictious royalty payment from Y co. to X co. which is reflection of the idea of the labor theory of value and which is in accordance with the contribution of real economic activities done by Y co. and X co. If international tax lawyers recognize existence of unreliable arm’s length transactions and give priority to income allocation according to physical contribution in affiliated enterprises as Y co. and X co., then fictious amounts of royalty payments in affiliated parties would be a bit smaller than royalty payments between arm’s length parties.

III-3. Second level: severe derogation from the arm’s length principle towards the standard of place of demand [42]

Now, discussion of international taxing rights allocation towards the standard of place of demand has already started (see, footnotes 2 and 5). Also the reasons have already been dis-

[42] The standard of place of demand has not been new in academic discussion since 1990s as Doernberg, footnote 23. Also see, Arthur Cockfield, “Tax Wars: The Battle Over Taxing Global Digital Commerce”, 161 Tax Notes 1331 (2018 December 18).

cussed[43]; user participation / user contribution, marketing intangibles, significant economic presence, or etc.

Why do we start to discuss the digital economy (this article does not deeply investigate the definition of digital economy), including the possibility to adopt the standard of place of demand? Why is mild derogation from the arm's length principle with improvement of the standard of place of production with the idea of the labor theory of value in section III-2 not enough? I try to make a model in the light of network effects in subsection III-3-1.

III-3-1. Model: scenario in which network effects require the standard of place of demand

Country R Country S
(a) XR (HQ: 20 + 10)------------------XS (subsidiary or branch: 10)
(b) YR (subsidiary or branch: 10)----YS (HQ: 20 + 10)

Let's suppose risky investment with network effects in a two-countries setting.

X co. which has a headquarters office (XR) in Country R has an affiliated entity (subsidiary or branch) in Country S (XS). Y co. has a headquarters office (YS) in Country S has an affiliated entity in Country R (YR). Country S has the market and X co. and Y co. compete each other. Network effects makes the loser in this competition to earn nothing and makes the winner earn everything, for example 100 (50 in Country R and 50 in Country S). For ease of discussion, competitors are only X co. and Y co. although in real competition there are many competitors and potential new comers. X co.'s possibility of winning is 50% and also for Y co. From the view point of X co., the estimated value of the success is 50 (= 100 x 50%). If the discount rate is 10%, then the discounted estimated value of the success is 45.45 (= 50/(1 + 10%)) if risk neutral is assumed. If risk averse is assumed, let's suppose that X co. invests 40. XR invests 20 for activities of R&D and 10 for marketing in Country R, and XS invests 10 for marketing in Country S. YS also invests 20 for activities of R&D and 10 for marketing in Country S, and YR invests 10 for marketing in Country R. Let's suppose that the winner is X co.

X co. invests 40 and the return is 100. The profit is 60. The discount rate is supposed to be 10%. Out of 60, 40 x 10% = 4 is risk free return. The difference of 6 between 44 and the estimated value of 50 is a risk premium. Residing 50 (= 60 – 4 – 6) is considered as a special profit derived from network effects (tentatively call, network effects profit: 50). In arm's length settings, 50 out of the 50 network effects profit is attributable to X co. and 0 out of the 50 is attributable to Y co. in the light of personal attribution of income.

We supposed that Country R and Country S are two countries above. The arm's length principle must be applied not only in international settings but also in domestic settings (al-

[43] See, 佐藤良「デジタル経済の課税をめぐる動向【第2版】」調査と情報-ISSUE BRIEF-No.1064（2019.7.2 http://dl.ndl.go.jp/view/download/digidepo_11299248_po_1064.pdf?contentNo=1）(Satô, Ryô, "Movement of digital economy taxation, second edition", Issue Brief, No. 1064 (2019 July 2)).

though applied provisions are different in international settings and domestic settings in Japanese law: Act on Special Measures Concerning Taxation, Article 66-4 and Corporation Tax Act, Articles 22(2) and 37). If R and S are two regions in one country (Tokyo and Osaka, Beijing and Shanghai, Berlin and München, or etc.), the arm's length principle must be applied as same as in international settings.

If R and S are two regions in one country, is profit attributable to XS calculated as 1/4 of risk free return (1 = 10 x 10%)? If so, profit attributable to XR is 59 (= 60 – 1). Even if 1/4 of risk free return and 1/4 of risk premium is attributable to XS (1 + 1.5 = 2.5), profit attributable to XR is 57.5 (= 60 – 2.5). Don't you think that XS's profit (1 or 2.5) is too small? If XS's profit is calculated as 15 (= 60 x 1/4), it is pure form of formulary apportionment, which has been denied in the tradition in the international tax law system although it has been adopted in domestic settings. If the arm's length principle is same both in international settings and domestic settings, it is reasonable to ignore the pure form of formulary apportionment. But, again, don't you think that XS's profit (1 or 2.5) is too small? 15 is not defendable but many tax lawyers would try to propose a figure between 2.5 and 15. It might be unreasonable that 0 out of the 50 of network effects profit is attributable to XS; if you think so, you might also agree in international settings that the strangeness *de lege ferenda* in the *Adobe* transfer pricing case (see, footnote 35) is not only based on arbitrary bearing of risk but also on another factor.

The strangeness in the *Adobe* transfer pricing case (although the result was right *de lege lata*) is that the result that profit attributable to XS is 1 or 2.5 is based on arm's length comparables before it is clear whether X co. would win or not but, in the real case, *Adobe* group enterprises had already known who was the winner.

This strangeness has two points. First, if R and S have the same tax rate (regardless whether two countries or two regions in one country), then XS and XR would not enter into an arrangement that all of the network effects profit is attributable to XR. Second, arm's length comparables without knowledge of the winner are not appropriate comparables when affiliated enterprises already know of the winner.

However, profit attributable to XS can hardly exceed 1 or 2.5 even though we legislate mild derogation from the arm's length principle in section III-2 in order to reinforce the standard of place of production with the idea of the labor theory of value. It is because that there is no logical base in the statement that a part of network effects profit is correspondent with contribution of real economic activities done by XS. Therefore, it might be possible to consider that we need not only mild derogation from the arm's length principle reinforcing the standard of place of production but also severe derogation from the arm's length principle towards the standard of place of demand.

On the other hand, thorough application of the standard of place of demand would be too large a derogation from the existing international tax law system (although VAT has already adopted the destination principle).

The pure form of formulary apportionment in which some portion of the total profit of X co. shall be allocated to Country S' tax jurisdiction would also be difficult to accept.

First, the market intangible concept which is differentiated from standard advertisements can be interpreted as an attempt for allocating not all excess profit but only a limited amount to a country of demand. Second, when user participation / user contribution concept has meaning in a market, then the market tends to be largely affected by network effects. Third, arm's length comparables without knowledge of the winner are not appropriate comparables when affiliated enterprises already know of the winner as said above. In the light of these three points, I try to make remedy the strangeness in the *Adobe* case.

In the model above, there are no potential newcomers. If so, X co. and Y co. might be able to be merged.[44] In the model above, YS invests 20 for R&D, which overlaps XR's investment of 20 for R&D. Not only R&D investment but also all investment by Y co. can be considered as overlap. If X co. and Y co. are merged, overlap investments can be saved. In the model above with competition, total investment amount is 80 but if X co. and Y co. are merged, the total investment amount might be 60 (or 40). This article looks at overlap investment for R&D.

It might be possible to explain that difference between {prior knowledge of the winner} and {latter knowledge of the winner} is not in the context of evoking demand which the marketing intangible concept looks at, but in the context of saving investment. Allocation between R and S concerning profit derived from saving overlap investment for R&D might be suitable for a market in which network effects is strong. It might sound like formulary apportionment concerning 20 but it is not a pure form of formulary apportionment.

If all investment by Y co. is considered as overlap, 40 might be allocated between R and S; however, this explanation might be too radical because YS's investment of 10 for marketing activities and YR's investment of 10 for marketing activities are not limited in the context of digital economy. If we do not attempt radical allocation proposals, allocation between R and S concerning profit derived from saving overlap investment for R&D as above might be acceptable.

III-3-2. Withholding tax, limitation of deduction, or vanishing of corporate income tax

UN Model Tax Convention, Article 12(2) has allocated taxing right on business income to source tax jurisdiction according to the standard of place of demand and withholding tax has long been utilized. This type of the standard of place of demand is not exceptional in UN Model or in developing countries.

Nowadays, there are many propositions: withholding tax, equalization levy, digital service tax, or etc. Availability of foreign tax credit is an issue.

There are other propositions which limit deduction from payers' tax base: BEAT, diverted profit tax, etc. Reverse charge in the context of VAT is similar but reverse charge does not need ringfencing although, in the context of income taxation in the digital economy, ring-

[44] See, 渡辺安虎「M&Aがイノベーションを『殺す』？」日本経済新聞電子版2020.2.14（https://www.nikkei.com/article/DGXMZO55576770T10C20A2TCR000/）(Watanabe, Yasutora, "M&A 'kill' innovation?" Nihon Keizai Shimbun, 2020 February 14).

fencing is needed unless corporate tax adopts taxing rights allocation correspondent with demand thoroughly.

Corporate income tax might not be needed if individual income tax is appropriately imposed on individual investors, because the ultimate policy goal of income tax is redistribution from rich to poor people in the light of equity of distributive justice with little impact on efficiency. However, this policy talk belongs in the far future (see, chapter IV).

IV. Comparison between corporate income tax and value added tax

	Country Q	Country R	Country S
(5)		X co.<---sales income---	Y co.
(7)	Z<---capital income---	X co.<---sales income---	Y co.

Section II-1 supposes two countries situations as follows:

(5) X co. of Country R produces goods and sell them to Y co. in Country S, and earns business income.

Let's suppose three countries situations as follows:

(7) Mr./Ms. Z supplies money to X co. of Country R in money contribution or money lending and earns capital income of dividends income or interest income. X co. and Y co. are the same as in (5).

Roughly speaking, traditionally, individual income tax is a tax in the resident country of investors (Country Q), corporate income tax is a tax in the country of production (Country R) (derogations are discussed in section III-3), and value added tax is a tax in the destination country (Country S) (Mirrlees Review, footnote 38).

What is the difference for tax base between corporate income tax and value added tax? The standard answer written in tax law textbooks is the difference between taxation or non-taxation on normal return (opportunity cost of investment) (see, footnote 13). Corporate income tax's base includes normal return. Value added tax's base excludes normal return. Value added tax's base can be changed to include normal return if value added is calculated not as consumption type value added but as income type value added which deducts only depreciation costs, not all amount of investment amount at investment time.

Counter to the standard answer, corporate income tax in the real world includes some types of measures excluding normal return in an economic sense with R&D investment special deductions or special tax credits. Therefore, substantial parts of real corporate income tax are similar to value added tax concerning tax base.

Therefore, the proposition for abolishing corporate income tax and relying on value added tax, like the American proposition of DBCFT (destination-based cash flow taxation), is reasonable in the context of an economic policy debate although it is difficult in the context of a political debate.

I believe that it is an efficient proposition that corporate income tax be changed to become similar to value added tax even though it is politically difficult. Standard tax law textbooks recommend rate reduction with broadening tax base, but excluding normal return from tax base means narrowing down tax base with rate hike. Therefore, such reformation of corporate income tax would hardly be supported by the populace. Although I recognize difficulties of such reform, it can be stated that the difference between corporate income tax and value added tax has little meaning among economic scholars at least.

If the difference for tax base between corporate income tax and value added tax is not as big as it looks, the difference for international taxing rights allocation between corporate income tax and value added tax can hardly be justified.

I believe that the standard of place of demand has resistance against tax competition regardless whether corporate income tax or value added tax; however, it is also discussed that tax according to the standard of place of demand can be burdensome for consumers[45] and therefore, tax revenue in a country of demand might rise but economic welfare in the country is vague. I do not have enough counter evidence.

Historically, it has long been discussed that international corporate taxing rights allocation according to the standard of place of production can trigger outflow of capital such as outbound transfer of factories or labors and can escalate bad effects of tax competition,[46] and I also have thought so. However, even in the context of value added tax, it is also discussed that the origin principle (if applied worldwide) does not necessarily distort trade terms; if the discussion has implications in the context of corporate income tax, it might be suggested that we do not need to be hostile against the standard of place of production.

Corporate income tax is usually categorized as direct tax, but equity in the context of distributive justice is not important for corporate income tax[47]; therefore, it also is similar to value added tax. In limited situations, corporate income tax is concerned with equity when corporate income tax is concerned with individual business income tax. Most corporate income tax propositions since the end of the 20th century treat business income equally regardless whether business entities take forms of corporation, partnership, trust, individual, or etc. However, there are few discussions concerning the relationship[48] between business income taxation which can disregard equity aspects and other individual income taxation which cannot disregard equity aspects. Therefore, I have not yet fixed my opinion, but I can say that similarity between corporate income tax and value added tax will be discussed more and more in the near future.

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[45] See, 三善由幸「地方法人税の分割基準が住民の厚生に与える影響の研究」(2017 https://www.rieti.go.jp/jp/publications/nts/17e124.html) (Miyoshi, Yoshiyuki, “Study of effects on welfare of residents affected by allocation criteria of local corporate tax”).

[46] Grinberg, footnote 30 (the former), p. 103 discusses that three factors formula (sales, asset, and labor) in American state tax law has disturbed enterprises’ investment in the state.

[47] Equity has several meanings. This article treats equity in distributive justice and equity is concerned with method of measuring economic power when we say about horizontal equity and vertical equity.

[48] Dual BEIT exceptionally considers this relationship. See, Edward Kleinbard, “Business Taxes Reinvented – A Term Sheet”, 156 Tax Notes 999 (2017 August 21).

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