

## **TAXES - The Tax Magazine (2006 to Present), Setting Aside International Nexus: Have Taxing Jurisdictions Been Preoccupied with Whether or Not They Could, Without Stopping to Think if They Should?, (Feb. 13, 2024)**

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Since the compromise at the League of Nations in 1928, the international income tax concept of “nexus,” under which a jurisdiction may claim the right to tax income, has enjoyed a long period of consensus and stability. This idea of international nexus includes a jurisdiction's right to tax: (i) income on the basis of residence or source (as limited by the jurisdiction's income tax treaties), and (ii) the business profits of a nonresident when (and only when) the nonresident maintains a physical presence within the jurisdiction that rises to the level of a permanent establishment. These concepts underlie all international income tax treaties and, until recently, have been regarded as fundamental guiding principles of international tax policy and law. Our analysis begins in Part I with a discussion of the principles of jurisdiction to tax on the basis of source and residence, the compromise of the League of Nations, and permanent establishment.

The concept of permanent establishment in the international tax space is similar to the “nexus” concept in the State tax space. Generally, a source country is not permitted to tax the business income of a nonresident unless the activities of the nonresident rise to the level of a permanent establishment in the country. When the nonresident's activities rise to the level of a permanent establishment, the source country is permitted to tax the profits of the nonresident, but only those profits connected to the permanent establishment. This rule arises pursuant to the business profits article of a bilateral income tax treaty (the “PE Requirement”) and, therefore, only applies between countries that have entered into such a tax treaty. Similarly, in the State tax space, a State is not permitted to impose a tax on a nonresident unless the nonresident has sufficient nexus ( *i.e.*, a threshold of required minimum contact) with the State. When a nonresident has sufficient nexus with the State, the State is permitted to tax the income from activity of the nonresident to the extent sourced to the State.

Permanent establishment is tied to, and is a measure of, a nonresident's physical presence in a country. Historically, nexus also has been tied to a nonresident's physical presence in a State. In the State tax context, the rise of the Digital Age has brought about a complete break between physical presence and nexus. Relatedly, as businesses have become more mobile, States have moved to embrace sourcing factors that connect income to States that are not mobile, specifically, revenue a taxpayer earns from customers within a State. Finally, because corporate groups operate as a single unit, States have embraced systems that apportion taxing rights to income that ignore the separate entity status of groups of entities that operate as a unit. Part II of our discussion reviews and analyzes these trends in State tax.

The trajectory of the international tax community's response to the rise of the Digital Age has been less coherent, especially with respect to permanent establishment. Countries began to introduce extraterritorial tax regimes with goals that focused less on preventing tax avoidance and more on circumventing the limitations of the PE Requirement. Specifically, in 2015, the United Kingdom (the “UK”) introduced its diverted profits tax (“DPT”) that included an avoidance of permanent establishment rule (“Avoidance of PE Rule”), which, under certain circumstances, essentially deemed a permanent establishment to exist when there was not one. Then, beginning

in 2019, countries began rushing to implement digital services taxes (“DSTs”), which are taxes on the revenue of enterprises earned with respect to the provision of certain digital services, such as the provision of a digital interface, digital advertising, and user data. The rise of these regimes indicated, as in the State tax scenario, a dissatisfaction with the PE Requirement and a view that physical presence (and the degree of physical presence) no longer provided a workable threshold to determine the point at which a nonresident should become subject to tax. This presented an issue because, among other reasons, it breached the compromise between the source jurisdiction and the residence jurisdiction that the PE Requirement represents. The compromise is that, until the PE Requirement is satisfied, the residence country has the right to tax all of the income of its resident. Then, once the PE Requirement is satisfied, the source country has the right to tax all of the income associated with the permanent establishment. If the source country imposes a tax absent a permanent establishment, it is having its cake and eating it too, appropriating taxing rights absent a permanent establishment, and still laying claim to full taxing rights when there is a permanent establishment in the source country. Thus, if permanent establishment was to survive as a compromise between source and residence countries, regimes like the DPT and DSTs appeared to call for a renegotiation of the parameters to determine what constitutes a permanent establishment. That renegotiation did not happen.

Instead, in the wake of a wave of jurisdictions implementing DSTs, and the threat of a second wave of more DSTs, the Organization for Economic Co-operation and Development (“OECD”)/G20 Inclusive Framework on Base Erosion and Profit Shifting (“BEPS”) (the “Inclusive Framework”) formally adopted the two-pillar solution to address tax challenges arising from the digitalization of the world economy. As we address below, the two pillars leave permanent establishment in its current form largely intact and, in certain aspects, employ permanent establishment far beyond its current application. Pillar I would be implemented by multilateral convention. Pillar II, on the other hand, is a design for unilateral measures to be implemented on a jurisdiction-by-jurisdiction basis. One of the components of Pillar II, “UTPR” (a provision that we discuss in detail below) innovates a tax that a jurisdiction imposes on a resident corporation or permanent establishment with respect to income that is not sourced to the taxing jurisdiction and that is not earned by a resident of the taxing jurisdiction. Like the other unilateral measures mentioned above, the DPT and DSTs, UTPR would be implemented, either, in violation of existing tax treaties or in a manner contrived to avoid treaty obligations. For this reason, these regimes, the DPT, DSTs, and UTPR, are referred to as “Treaty Avoidance Regimes.” We describe and analyze these regimes in Part III.

In Part IV, we analyze whether countries implementing Treaty Avoidance Regimes succeed in avoiding their obligations under tax treaties. We also draw from our earlier State tax discussion (in Part II) to explore whether enactment by Congress of similar provisions would fail constitutional muster.

In Part V, we consider whether and to what extent a fundamental readjustment to the concept of international nexus is warranted, and what alternatives to the current trajectory still may exist. In Part VI, we conclude.

## **I. Source, Residence, Permanent Establishment, and the Compromise of the League of Nations**

Tracing back to the League of Nations, countries have recognized two, and only two, legitimate grounds for a country to claim jurisdiction to tax international income: source and residence. <sup>[1]</sup> If the source of an item of income is from within a country and the income is earned by a person who resides outside of that country, the source country has a legitimate claim to tax the income of the nonresident. If the source of an item of income is from outside of a country, but the income is earned by a resident of the country, the residence country has a legitimate claim to tax the income of its resident. The competing claims between source and residence countries resulted in the fundamental issue that the League of Nations sought to solve: double taxation. <sup>[2]</sup> Specifically, if both the source country and the residence country tax an item of international income, the result is that the item of income is taxed twice. The sentiment leading up to the League of Nations’ compromise in the 1920s was that, even though a source jurisdiction and a residence jurisdiction each has a legitimate claim to tax an item of

international income, it is nevertheless an inappropriate result for the same item of income to be taxed twice. <sup>[3]</sup> It is important to pause here, however, to reflect that, even before the League of Nations approached the issue of double taxation, the premise was, and since has been, that source and residence are the only legitimate bases for a country to claim jurisdiction to tax income.

Moving on from that fundamental premise, the framework for the League of Nations' compromise to avoid double taxation has generally been characterized as one that distinguishes between active business and passive income. <sup>[4]</sup> Source jurisdictions generally keep the right to tax active business income and forgo the right to tax passive income, and residence jurisdictions generally keep the right to tax passive income and forgo the right to tax active business income. <sup>[5]</sup> Thus, a source jurisdiction generally yields the right to tax passive income items, such as dividends, interest, and royalties, and has the sole right to tax business ( *i.e.*, active) income. <sup>[6]</sup>

This compromise fundamentally relies on and is modified by the key principle of permanent establishment.

<sup>[7]</sup> The permanent establishment principle is appropriately viewed as a limitation on a source jurisdiction's right to tax business income. <sup>[8]</sup> It generally limits a source jurisdiction's right to tax international income to circumstances when the income is related to a fixed physical presence in the source country through which business operations that are directly related to the production of such income are conducted. <sup>[9]</sup> Mitchell B. Carroll, a member of the American delegation to the League of Nations, <sup>[10]</sup> described the circumstances that highlighted the need for the permanent establishment compromise. He wrote:

After World War I when governments were in dire need of revenue to rebuild their economies, they began to try to tax the earnings of the visiting businessman and the profits of the foreign company on goods sold through him. Canada even tried to tax a United States firm on profits from advertising its wares and receiving mail orders from customers in its territory. In the early 1920s, the British Board of Inland Revenue sought to impose liability... [on] sales through a local commission agent... [e]ven if the nonresident and his British intermediary took pains to conclude the contract abroad.... <sup>[11]</sup>

Apparently, even one hundred years ago, doing business in another country without a fixed physical presence was prevalent enough that countries saw taxing such activity as an attractive source for generating tax revenue. These tax regimes implemented by source countries desperate for tax revenue resulted in double taxation. Thus, another objective of the League of Nations was to reach a consensus that would restrict source countries' rights to tax business income to instances in which the income relates to a fixed physical presence in the source country. <sup>[12]</sup>

The compromise of the League of Nations is reflected in bilateral treaties, based on the model prepared by the League of Nations in 1928. <sup>[13]</sup> Treaties generally operate to set boundaries on source countries' rights to tax income and place the burden of mitigating double taxation on residence countries. <sup>[14]</sup> As noted above, the model treaty took different approaches to limiting source countries' rights to tax passive-type income and their rights to tax active (business)-type income. With respect to passive-type income, the limitation is a fixed percentage that varies between treaties based on the agreements reached between the contracting states. For example, it is common in U.S. income tax treaties for the contracting states to agree that a source country fully relinquishes its right to tax royalties (sometimes subject to specific exceptions). <sup>[15]</sup> In some treaties, however, the source country's right to tax royalties is subject to a ceiling instead of being relinquished entirely. <sup>[16]</sup> In some of those countries, the ceiling for taxing royalties depends on the type of royalty. <sup>[17]</sup> The same is true for interest, as in some cases the source country relinquishes all rights (sometimes subject to specific exceptions), <sup>[18]</sup> in others there is a ceiling, <sup>[19]</sup> and yet in others there is a ceiling that varies depending on the type of interest. <sup>[20]</sup> The source country generally retains the right to tax a certain percentage of dividends, except when the

dividend is from a corporate subsidiary to a corporate parent, in which case it is common for the source country to relinquish its right to tax dividends. <sup>[21]</sup>

The boundary that treaties place on a source country's right to tax business income is all-or-nothing, based on whether the business income is attributable to a permanent establishment inside the source country. <sup>[22]</sup> The compromise with respect to the taxation of business profits was viewed as "the most important field of agreement" among the committee of technical experts appointed by the League of Nations. <sup>[23]</sup> The permanent establishment rule in the business profits provision in treaties is relatively standard. For example, the "Business Profits" provision in Article 7, paragraph 1 of the U.S. Model Treaty provides:

The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.

The next paragraph of the U.S. Model Treaty explains that the business profits attributable to the permanent establishment are the business profits that "it might be expected to make... if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions." <sup>[24]</sup> The first two paragraphs of the OECD Model Treaty's "Business Profits" provision are roughly the same. <sup>[25]</sup> These paragraphs, and their like in other treaties, are the PE Requirement.

Having established a PE Requirement, the next step is to determine what constitutes a permanent establishment. With some, but not much, variation between treaties, an enterprise has a permanent establishment in a country if either of two situations applies. First, an enterprise has a permanent establishment if it has a fixed place of business in the country through which the enterprise carries on a business ( e.g., an office, factory, mine, etc.). However, a "fixed place," for this purpose, excludes business activities where the only activities conducted are of a preparatory or auxiliary nature with respect to the business of the enterprise ( e.g., facilities solely for the purpose of storage, display, or delivery of goods belonging to the enterprise, a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise). <sup>[26]</sup> Second, an enterprise has a permanent establishment in a country if an agent of the enterprise who is in the country, other than an agent of independent status, regularly negotiates or concludes contracts on behalf of the enterprise. <sup>[27]</sup> Thus, for example, an officer or employee of an enterprise who regularly concludes contracts on behalf of the enterprise in a country will generally give rise to a permanent establishment. <sup>[28]</sup> On the other hand, an agent of independent status, a person acting as an agent for an enterprise in pursuit of its own separate business operation ( e.g., commission agents, independent distributors), generally does not create a permanent establishment for an enterprise, even if that agent habitually concludes contracts on behalf of the enterprise. <sup>[29]</sup>

The specific treaty provisions applicable to passive-type income and the business income provision that applies to active-type income limit a source country's right to tax income. However, a country's right to tax its residents generally is not limited. <sup>[30]</sup> It is possible to view this as a fundamental principle of tax treaties that goes without saying. <sup>[31]</sup> However, most treaties, including all U.S. treaties, contain what is commonly referred to as a "saving clause," which clarifies that, except with respect to certain enumerated provisions, the treaty does not limit a country's right to tax its residents. <sup>[32]</sup> This is why, for example, residence countries can include in their tax base income from foreign permanent establishments, partnerships, and controlled foreign corporations. <sup>[33]</sup>

However, even though residence countries do not relinquish their rights to tax income, treaties obligate them to mitigate double taxation. <sup>[34]</sup> Residence countries can mitigate double taxation in one of two ways. One way is

for the residence country to exempt from its own tax the income that the source country is permitted to tax. The other way is for the residence country to provide a tax credit for that tax paid to the source jurisdiction. <sup>[35]</sup>

The principles that underlie the compromise of the League of Nations are also reflected in aspects of U.S. federal income tax law. When it comes to the taxation of residents, the United States is generous, ceding its taxing rights to source countries through the provision of a foreign tax credit. <sup>[36]</sup> This serves to protect U.S. residents from double taxation, even in the absence of a tax treaty.

For nonresidents, the U.S. approach varies based on whether income is passive- or active-type income. With respect to passive-type income, the United States does not tax the foreign-source income of a nonresident, reflecting the principle that source and residence are the only two justifications for asserting taxing jurisdiction over income. <sup>[37]</sup> However, the United States does impose withholding tax on payments of U.S.-source, non-business income to nonresidents, asserting its jurisdiction to tax as a source country, absent a treaty. <sup>[38]</sup>

With respect to active (business) income, U.S. law abstains from imposing tax until, at least, a physical presence threshold is crossed. Specifically, the U.S.- and foreign-source income of a nonresident is not subject to U.S. tax unless the income is effectively connected to the conduct of a trade or business inside of the United States. <sup>[39]</sup> One requirement for a trade or business to be conducted inside the United States is that the activity must be tied to a physical presence in the United States. For example, in *Piedras Negras Broadcasting Co. v. Commissioner*, <sup>[40]</sup> a radio station in Mexico broadcasting English language programming into the United States was not subject to U.S. income tax on its advertising revenue because the radio station had no physical presence in the United States and thus did not have a U.S. trade or business. Congress' hesitation to tax foreign business income absent physical presence and the treaty approach, requiring a permanent establishment before a source country has the right to tax income, reflect a historical and consistent commitment to what can be viewed as a physical presence minimum standard to taxing international business income. This same commitment was even more pronounced in the State tax context until recently. As many have observed, the movement in the State tax space, shifting away from a physical presence standard, can provide helpful insight into the similar trend in international tax law.

## II. Developments and Lessons from State Tax Nexus

In the State law context, a nexus constraint is imposed under both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause. The State tax constraints imposed by the Due Process Clause and the Commerce Clause are discussed in Part II.A. Historically, this nexus constraint had imposed a physical presence requirement and prevented States from imposing sales and use tax on a taxpayer that had no physical presence in the State. The Supreme Court's interpretation of the nexus requirement eroded over time until, in *South Dakota v. Wayfair, Inc.*, the Court concluded that, as a result of the rise of the Digital Age, the nexus requirement no longer could require physical presence. The Supreme Court history of the nexus requirement is discussed in Part II.B. It was never clear whether the physical presence nexus requirement for sales and use tax also applied to State income tax. However, another constitutional constraint on State taxation—the benefits requirement—is closely related to the nexus requirement. As we explore below, the benefits requirement limits a State's taxing rights to income connected to the taxpayer's nexus with the State. This means that a State only has the right to tax income sourced to the State. The benefits requirement is discussed in Parts II.C and II.D. From early on, the Court has permitted states to source income (and thus satisfy the benefits requirement) by applying either a separate accounting approach or formulary apportionment. Initially, an apportionment method referred to as the Massachusetts Formula was ubiquitous among the States that had an income tax, but, over time, the majority of States moved to the single factor sales method. Formulary apportionment and the shift from the Massachusetts Formula to single factor sales is discussed in Part II.D. Another trend among States that gained popularity during the Reagan administration was world-wide combined reporting ("WWCR"). Under WWCR, a State would combine the income of all entities related to the taxpayer (who were engaged in a unitary business) and apply the State's formula for formulary apportionment (including all of the formula factors of the



group) to determine the income of the taxpayer subject to tax in the State. WWCR, and the Supreme Court's approval of WWCR, are discussed in Part II.E.

## A. Due Process and the Commerce Clause

Constitutional challenges to State taxes for lack of nexus have been made under the Due Process Clause of the Fourteenth Amendment and under the Commerce Clause of Article 1. The Due Process Clause generally prevents a State from depriving a person of life, liberty, or property when such deprivation is not justified by a sufficient purpose. In the context of State taxation, this principle applies to require that the taxing power exerted by the State bear a fiscal relation to protections, opportunities, and benefits given by the State. <sup>[41]</sup> This Due Process requirement breaks down into two parts: (i) a minimum contacts requirement, which looks at whether there is sufficient contact between the State and the taxpayer to justify the State's imposition of a tax on the taxpayer; and (ii) a benefits requirement, which looks at whether there is a sufficient relationship between the benefits the taxpayer derives from the State and the tax the State seeks to impose. <sup>[42]</sup>

The Commerce Clause prohibits States from acting in a manner that discriminates against or unduly burdens interstate (or international) commerce. A State does not unduly burden interstate commerce only if the State tax is designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys. <sup>[43]</sup> A four-part test applies to determine whether a State tax violates the Commerce Clause, requiring that the tax: (i) applies to an activity with a substantial nexus with the taxing State; (ii) is fairly apportioned; (iii) does not discriminate against interstate commerce; and (iv) is fairly related to services provided by the State. <sup>[44]</sup>

## B. History of Physical Presence in State Tax Jurisprudence

As provided above, both the Due Process Clause and the Commerce Clause have been interpreted to impose a nexus requirement in the State tax context. The Due Process Clause nexus requirement is a minimum contacts test, and the Commerce Clause requires that an activity have substantial nexus with the taxing State. Historically, both nexus requirements imposed a physical presence limitation with respect to State sales and use tax as reflected in *National Bellas Hess, Inc. v. Department of Revenue*. <sup>[45]</sup> *National Bellas Hess, Inc.* ("National"), a mail order company, challenged an Illinois tax that imposed use tax on in-state buyers and that sellers, including out of state sellers, were obligated to collect and remit. Twice a year, National would mail order catalogues throughout the United States to its active or recent customers, including to customers in Illinois. National would also occasionally mail out advertising flyers to past and potential customers. Finally, National would send goods ordered by customers through the mail or by common carrier. From these facts, the Court concluded that National's only connections to Illinois were through mail and common carriers. In this sense, National had no physical presence in Illinois and, as a result, the Court sided with National, holding that the Illinois tax violated the nexus requirement of the Due Process Clause and the nexus requirement of the Commerce Clause. In other words, under *Bellas Hess*, the minimum contacts required to pass muster under both the Due Process Clause and Commerce Clause was physical presence.

Twenty-five years later, the Court, in *Quill Corp. v. North Dakota*, <sup>[46]</sup> changed its mind, concluding that the nexus requirement of the Commerce Clause required physical presence, but the nexus requirement of the Due Process Clause did not. The relevant facts in *Quill* were indistinguishable from the facts in *Bellas Hess*. However, while, in the context of State tax, *Bellas Hess* and earlier Supreme Court decisions saw the Due Process Clause and Commerce Clause requirements as "similar," *Quill* viewed the two clauses as posing "distinct limits on the taxing powers of the States." <sup>[47]</sup> The Court explained its departure from its prior decisions, citing an evolution in the Court's jurisprudence in the context of Due Process and judicial jurisdiction. In this sense, the Court moved away from a "formalistic" physical presence standard to a more "flexible approach" that looked at whether a "corporation purposefully avails itself of the benefits of an economic market in the forum State." <sup>[48]</sup> This shift, the Court explained, was necessitated by the new realities of "modern commercial life." <sup>[49]</sup> Turning back to the

Commerce Clause, however, the Court aligned with *Bellas Hess* and concluded that the nexus requirements for the Due Process Clause and Commerce Clause are not identical. The nexus requirement under only the Commerce Clause requires physical presence.

This was an important shift because it opened the door for Federal legislation to permit States to impose a tax on inbound commerce even absent physical presence. If physical presence was required to satisfy the Due Process Clause nexus requirement, Congress would have no power to permit states to violate Due Process. However, now that physical presence was required only to satisfy the nexus requirement of the Commerce Clause, Congress, which, unlike the States, is empowered to regulate interstate commerce, could permit States to impose tax on interstate commerce even when the source of the commerce was not related to a physical presence in the taxing State. Congress never ended up exercising its new ability to empower states to tax interstate commerce in this manner. It would take almost four decades for the Supreme Court to find its truth, at last, in *Wayfair*. <sup>[50]</sup>

Unlike *Bellas Hess* and *Quill*, *Wayfair* did not concern a mail order company, but instead concerned three Internet market place companies, Wayfair, Overstock.com, and Newegg. Nevertheless, the salient issue was the same: Can a State impose sales tax on an out-of-State seller that has no physical presence in the State? The Court overturned *Quill* based on how the rise of the Internet and Cyber Age have “changed the dynamics of the national economy.” <sup>[51]</sup> The Court’s explanation for its change of heart can be summarized simply: Before the rise of the Internet, interstate commerce without a physical presence in a State was a small fraction of national commerce. After the rise of the Internet, such commerce became a large fraction of national commerce. In sum, the new digital economy meant that physical presence could no longer be the threshold for State taxation of interstate business.

### C. Constitutional Standards Applicable to Income Tax—Nexus and the Benefits Requirement

It is important here to reflect that this arc from *Bellas Hess* and its predecessors to *Wayfair* specifically concerned sales and use tax and, throughout, it was unclear to what degree similar nexus principles applied to State income tax. Case law reviewing whether or not similar nexus principles apply generally arose during the period between *Quill* and *Wayfair*, with their focus thus being on whether it is permitted under the Commerce Clause for a State to impose its income tax on a taxpayer that has no physical presence in the State. <sup>[52]</sup> In line with the general trajectory of the Supreme Court’s jurisprudence, there was at first a trend among State courts to apply a physical presence limitation that eventually gave way to an opposing trend to limit *Quill*’s physical presence requirement for nexus to sales and use tax. <sup>[53]</sup> Of course, the issue became moot when in *Wayfair* the Supreme Court decided that no constitutional nexus requirement imposed a physical presence requirement even in the context of sales and use tax.

The more interesting constitutional requirements that apply equally between sales and use tax, on one hand, and income tax, on the other, are the benefits requirements under the Due Process Clause and Commerce Clause. Specifically, aside from the minimum contacts requirement that is generally characterized as the “nexus” requirement, both the Due Process Clause and the Commerce Clause require that there be a connection between the income the State seeks to tax and the activities in the State. In *Commonwealth Edison Company v. Montana*, <sup>[54]</sup> the Supreme Court explained that the benefits requirements look at whether the tax is in proportion to the taxpayer’s contact with the State. Montana imposed a severance tax on each ton of coal mined in Montana, including coal mined on federal land. The tax rate varied, depending on the value, energy content, and method of extraction of the coal, but was capped at 30% of the contract sales price of the coal. The tax, of course, did not relate to any special benefits that Montana supplied to the coal mining industry. The taxpayers specific challenges were under the Commerce and Supremacy Clauses, but the Supreme Court provided some discussion of the Due Process Clause as well. Specifically, the Supreme Court aligned, in concept, the benefits requirements of the Due Process Clause and Commerce Clause, concluding that neither of the

benefits requirements call for a relationship between a State tax and a taxpayer's benefits from a State. Rather the benefits requirements relate to a taxpayer's fair share of supporting the common good. In that respect, under the benefits requirements, "the question is whether the State has exerted its power in proper proportion to appellant's activities within the State and to appellant's consequent enjoyment of the opportunities and protections which the State has afforded." [55] For this purpose, the benefits requirement is "closely connected to" the nexus requirement, with the nexus requirement establishing a "threshold test" and the benefits requirement looking "[b]eyond that threshold requirement," requiring that "the *measure* of the tax must be reasonably related to the extent of the contact, since it is the activities or presence of the taxpayer in the State that may properly be made to bear a 'just share of state tax burden.'" [56]

## D. The Benefits Requirement and Formulary Apportionment

In the context of income tax, the benefits requirement is stated simply: "Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, 'tax value earned outside its borders.'" [57] When a taxpayer conducts interstate and/or international business, the difficult question is, how does the taxpayer determine the value attributable to a particular State? One option would be for a taxpayer to prepare a separate accounting of its operations in each State. However, early on, States instead looked to the unitary business principle and formulary apportionment. [58] When the activities of a taxpayer are parts of an integrated, interdependent, synergistic whole, each part can be viewed as a component of a unitary business. Then, when such unitary business operates in interstate (or international) commerce, a formulary apportionment approach takes the combined income of the unitary business and apportions it to States based on a formula. [59] The Supreme Court in *Underwood Typewriter Co. v. Chamberlain* [60] confirmed the use of formulary apportionment instead of separate accounting to source a taxpayer's income to a State and its compliance with the benefits requirement.

An early popular method employed by States, known as the Massachusetts Formula, looked at and equally weighted three factors: the taxpayer's property, payroll, and sales. [61] Thus, for example, if all of a taxpayer's property and payroll were in State X and all of its sales were in State Y, under the Massachusetts Formula, 67% of the income of the taxpayer would be attributable to State X and 33% would be attributable to State Y. In 1978, 43 of the 44 states that had a corporate income tax used the Massachusetts Formula to determine the amount of a taxpayer's income that was allocable to each state. [62] Iowa was the odd State out, opting to apply a single factor sales formula. [63] Instead of using multiple factors, a single factor sales formula apportions the income of a unitary business solely based on sales. Thus, under the example above, under Iowa's single factor formula, all of the income of the taxpayer would be apportioned to State Y, in spite of all of the taxpayer's property and payroll being in State X. Iowa's single factor test was challenged under the Due Process and Commerce Clauses in *Moorman Manufacturing Co. v. Bair*. [64] A key contention of the taxpayer was that Iowa's formula violated the Due Process Clause because its single factor sales formula looks to revenue and not profit. Thus, a single factor sales formula approximates revenue apportioned between the States, but not taxable income. This, the taxpayer contended, violated the benefits requirement of the Due Process Clause, which requires that "the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" [65] The Supreme Court rejected the taxpayer's argument, explaining that any formula is a rough approximation, so a formula's rough approximation based on revenue rather than income is permitted.

Post- *Moorman*, States flocked to the single factor sales formula, with the majority of states employing a single factor sales formula and many others employing a formula that doubled or tripled the weight of sales. [66] The allure of a single factor sales formula is readily apparent. Comparing a State implementing the Massachusetts Formula, State X, to a State implementing a single factor sales formula, State Y, a taxpayer always will be incentivized to extract operations from State X and move them into State Y for two reasons, illustrated as follows. Assume that 50% of T's sales are in State X and 50% are in State Y. T has \$100 of income. If T locates its



operations (property and payroll) in State X, State X will claim that \$82.50 of T's income is taxable in State X, and State Y will claim that \$50 of T's income is taxable in State Y. <sup>[67]</sup> Compare that to the alternative, where T locates all of its operations in State Y. In this scenario, State X will claim that only \$16.50 of T's income is taxable in State X, and State Y will not increase its claim that \$50 of T's income is taxable in State Y. State Y's regime is attractive to T because moving operations to State Y does not increase the amount of income that State Y views as allocable to itself and, for as long as T remains in State X, T's sales in State Y will be subject to double taxation.

## E. World-Wide Combined Reporting

Because formulary apportionment relies on the unitary business principle, an issue can arise when a unitary business is conducted by separate entities. This issue came before the Supreme Court in *Container Corp. v. Franchise Tax Board*. <sup>[68]</sup> The taxpayer was a Delaware corporation that operated in multiple U.S. jurisdictions including California. The taxpayer also had foreign corporate subsidiaries that operated outside of the United States. Under California's WWCR, the taxpayer was required to include all of the income of its unitary business, which included the income of the foreign subsidiaries, as income subject to apportionment. For the tax years in question, California applied the Massachusetts Formula and, as a result, the property, payroll, and sales of the foreign subsidiaries also were taken into account. Thus, "[i]ncluding the overseas subsidiaries in appellant's unitary business had two primary effects: it increased the income subject to apportionment by an amount equal to the total income of those subsidiaries... and it decreased the percentage of that income which was apportionable to California," with the "net effect" being to "increase appellant's tax liability." <sup>[69]</sup> Turning back to nexus, this is an interesting outcome, as the foreign subsidiaries had no apparent nexus with California and yet the income of those subsidiaries was subject to tax in California. Noting that "respect[ing] formal corporate lines... is not constitutionally required," the Court sided with California, holding that the income of the foreign subsidiaries could be attributed to their corporate owner when the subsidiaries and their owner operated a unitary business. <sup>[70]</sup> Although nexus considerations were important in the case, the more fundamental outcome of *Container Corp.* is its conclusion with respect to the benefits requirement, that a State is permitted to look through corporate and international divisions to combine the income and formula factors of a world-wide group of corporations to apportion income between taxing jurisdictions.

The Court reached the same outcome in *Barclays Bank PLC v. Franchise Tax Board of California*, <sup>[71]</sup> which involved a foreign-parented affiliated group of corporations. The case involved two corporations that did business in California, BBI, a UK corporation, and Barcal, a California banking corporation. BBI and Barcal were members of the Barclays Group, a UK based multinational banking enterprise of more than 220 corporations doing business in 60 nations. As in *Container Corp.*, the Court upheld California's WWCR and its right to take into account all of the income of the unitary business, even the income of the foreign owners of BBI, and apply such owners' property, payroll, and sales in the apportionment fractions for the unitary business. An amicus curiae filed by the Government of the United Kingdom specifically raised the issue that California was proposing to tax the income of entities that do not have nexus with California. The Court responded:

As the United Kingdom recognizes, the theory underlying unitary taxation is that "certain intangible 'flows of value' within the unitary group serve to link the various members together as if they were essentially a single entity." Formulary apportionment of the income of a multijurisdictional (but unitary) business enterprise, if fairly done, taxes only the "income generated within a State." *Quill* held that the Commerce Clause requires a taxpayer's "physical presence" in the taxing jurisdiction before that jurisdiction can constitutionally impose a use tax. The California presence of the taxpayers before us is undisputed, and we find nothing in *Quill* to suggest that California may not reference the income of

corporations worldwide with whom those taxpayers are closely intertwined in order to approximate the taxpayers' California income. <sup>[72]</sup>

As in its opinion in *Container Corp.*, the Court appeared to conclude that there is no constitutional obligation that a State tax respect formal corporate lines, permitting California to tax the income of BBI's foreign owners as though it were income of BBI and its subsidiary, Barcal. Thus, it seems, from a nexus perspective, when corporate affiliates conduct a unitary business, if any affiliate has nexus with a State, the Constitution does not prohibit the State from allocating all business income of the unitary business attributable to the State to the affiliate with nexus and taxing the affiliate accordingly. Of course, the more central issue in *Barclays* was whether California's WWCR regime violated the Due Process Clause and the Commerce Clause by "tax[ing] value earned outside [the taxing State's] borders." <sup>[73]</sup> On this issue, the Court affirmed that California's use of a reasonable approximation of the unitary business income satisfied the benefits requirement and found that California's WWCR regime passed constitutional muster.

California and other States' implementation of mandatory WWCR sparked outrage from the United States' trading partners and foreign businesses. <sup>[74]</sup> Critics of the regime complain that it amounted to States taxing the income of foreign residents on the income they earned abroad. <sup>[75]</sup> Of course this was absolutely true when income was sourced on a separate accounting basis. However, as the Supreme Court pointed out in *Container Corp.* and *Barclays*, the Constitution does not impose an obligation on a State to respect separate accounting. Rather, a State is permitted to source income to the State on the basis of formulary apportionment. In that sense, mandatory WWCR States would claim that they do not seek to tax income earned abroad, they seek to tax income sourced to their State from the application of formulary apportionment. Pressure mounted against mandatory WWCR, with the UK threatening retaliatory action. <sup>[76]</sup> As a result, President Reagan and his Treasury Secretary, Donald Regan, prevailed upon States (with the threat of Federal action) to implement "water's edge" limitations to their mandatory WWCR. Very generally, a water's edge limitation excludes entities from the combined group that are not subject to tax for U.S. federal income tax purposes. <sup>[77]</sup> Mandatory WWCR may be making a comeback in some States, <sup>[78]</sup> and, relevant to our discussion below, the Federal government may not be as critical this time around.

Source of income is not just a helpful tool in tax policy considerations. At least in the State tax contexts, source of income, under the benefits requirement, is a fundamental constitutional principle that a State must heed under both the Due Process Clause (of the Fourteenth Amendment) and the Commerce Clause. Later, in Part IV, we explore the extent to which the benefits requirement applies to Federal taxes under the Due Process Clause of the Fifth Amendment. We also observe relatively consistent patterns in State tax in addressing the issues with which the international community struggles. As volume of business ceased to relate to degree of physical presence, physical presence ceased to be determinative of nexus. As it became easier for companies to choose where to locate assets and hire employees, the majority of States shifted to a single factor sales apportionment, an approach quarter measured in Pillar I Amount A, <sup>[79]</sup> as we discuss in Part III.B. Since markets are the least mobile element of a business and are conveniently related to an enterprise's generation of income, single factor sales apportionment both satisfies a market jurisdiction's claim as source of income and prevents tax competition and a race to the bottom. Finally, when States viewed separate entity status and offshoring of income as problematic, States moved to WWCR until the Reagan administration threatened to shut the practice down. None of this is to say that State tax does not have a host of its own issues, but, as we demonstrate, the State tax path to solving the major issues that the international tax world is in the midst of dealing with shows a more straightforward and consistent pattern than what we observe with respect to the Treaty Avoidance Regimes.

### III. Treaty Avoidance Regimes

Back in the Reagan years, the United States needed to rein in the States from expanding their tax bases internationally for the United States to avoid retaliation from its trading partners, as they decried the violation of international tax norms. Today, the shoe is on the other foot, and the United States' trading partners are the ones making moves to expand their tax bases contrary to international tax norms, with the United States (weakly and halfheartedly) threatening retaliation. In this Part III, we discuss the Treaty Avoidance Regimes: the DPT, DSTs, and UTPR. Two of these regimes, the DPT and DSTs, can be viewed as revealing countries' dissatisfaction with the PE Requirement's imposition on their rights, as market jurisdictions, to tax international income. Such dissatisfaction aligns with the State tax trends reflected in *Wayfair* and the movement towards single factor sales apportionment. Specifically, the DPT and DSTs reflect attitudes that: (i) permanent establishment no longer supplies a meaningful threshold to establish or limit a source country's taxing rights, and (ii) source of income should be more closely tied to market access. In this Part, we also discuss UTPR. As a part of the Pillar II regime initially presented by the OECD, UTPR would have represented a sweeping change to the international tax landscape, but not a change that challenges the core fundamentals of the international tax system. We track UTPR's progress to what it has become, which is a regime that rejects the historical boundaries of taxing jurisdiction, adopts a puzzling form of formulary apportionment, and imbues permanent establishments with more importance than ever before.

## A. Diverted Profits Tax

The DPT applies in two circumstances. One circumstance involves a situation in which a UK entity or a UK permanent establishment enters into an arrangement with a related party, has insufficient economic substance, and leads to an effective tax mismatch outcome. <sup>[80]</sup> The other circumstance, which we focus on, applies when the DPT views a foreign company as avoiding a UK taxable presence. <sup>[81]</sup> This arm of the DPT, the Avoidance of PE Rule, involves a foreign company (a company that is not a UK resident) and an "Avoided PE." <sup>[82]</sup> An Avoided PE generally is a person carrying on activity in the UK in connection with the supply of goods or services made by the foreign company to customers in the UK, but the activity is not carried on through a UK permanent establishment. <sup>[83]</sup> The Avoidance of PE Rule applies when: (i) it is reasonable to assume that the activity of the foreign company and/or Avoided PE are designed to avoid conducting activity through a UK permanent establishment, and (ii) either a mismatch condition or a tax avoidance condition is met. <sup>[84]</sup> Focusing on the tax avoidance condition, it generally applies when, with respect to the Avoided PE or foreign company, arrangements are in place one of the main purposes of which is to avoid or reduce a charge to UK corporation tax. <sup>[85]</sup> When the Avoidance of PE Rule applies, the tax is imposed on the foreign company. The tax can be collected from the Avoided PE as a representative of the foreign company. <sup>[86]</sup>

The "diverted profits" upon which the DPT is charged (when the Avoidance of PE Rule applies only as the result of the application of the tax avoidance condition) are the chargeable profits of the foreign company had it had a UK permanent establishment. <sup>[87]</sup> The tax rate for the DPT is 31%, which is higher than the 25% UK corporate tax rate. <sup>[88]</sup> Furthermore, the DPT must be paid when assessed without a right to delay payment until after a proceeding establishing the rightful application of the DPT. <sup>[89]</sup> Finally, the DPT does not apply to small- or medium-sized enterprises or to groups with UK related sales below GBP 10 million or UK-related expenses below GBP 1 million. <sup>[90]</sup>

Although styled as an anti-abuse measure, the Avoidance of PE Rule much more closely resembles a regime implemented out of the UK's dissatisfaction with its treaty arrangements. Simply understood, the exact purpose of the permanent establishment provision in an income tax treaty is that if a foreign enterprise can operate in a treaty jurisdiction without operations rising to the level of a permanent establishment, then the jurisdiction does not have the right to tax the business profits of the foreign enterprise. One can imagine an anti-abuse provision that addresses fictitious arrangements implemented to avoid a permanent establishment, but the Avoidance of PE Rule does not have such a limitation. Rather, one could see the Avoidance of PE Rule

applying in almost any scenario in which an enterprise has operations in the UK that do not rise to the level of a permanent establishment, and those UK operations are connected to the commercial activities of a non-UK company operating in a jurisdiction that has a corporate tax rate that is lower than the UK's corporate tax rate. For example, a UK marketing company providing marketing services for a U.S. manufacturer and seller may be subject to the Avoidance of PE Rule. The U.S. company will almost certainly have arrangements in place to avoid having the UK marketing company negotiate or make UK sales specifically to avoid having a UK permanent establishment. There is nothing apparently abusive about such an arrangement, as the tax treaty between the United States and the UK specifically provides that the UK cedes its taxing rights when a U.S. company operates in the UK without a fixed place of business in the UK and without a dependent agent in the UK who habitually exercises authority to conclude contracts that are binding on the U.S. company.

<sup>[91]</sup> It may be the case that the limitations the United States-UK tax treaty places on what constitutes a permanent establishment are obsolete in the modern economy, but that argument implies that the DPT was not implemented to curb taxpayer abuse, but rather to facilitate UK treaty avoidance.

It is also worth noting that the broad sweep of the Avoidance of PE Rule and the punitive nature of the DPT (charged at a higher rate and with fewer process protections) combine to incentivize foreign businesses to concede permanent establishments in the UK rather than run the risk of becoming subject to the DPT. In other words, the Avoidance of PE Rule has an apparent design component to incentivize taxpayers not to avail themselves of the treaty protection to which they are entitled. This too implies a motivation, on the part of the UK, unrelated to tax avoidance and, instead, related to eroding the tax base of its treaty partners. In our example above, if the Avoidance of PE Rule were applied to the U.S. company, the company would be subject to both the DPT and U.S. tax with no ability to credit the DPT paid against U.S. tax. <sup>[92]</sup> Seeking to avoid the risk of such an outcome, the U.S. company may opt to restructure so as to have a UK permanent establishment, and as a result, be subject to UK corporation tax. This way, double taxation would be mitigated by the United States. <sup>[93]</sup> Had the UK abided by its treaty obligations, it would not have taxed the U.S. company and the United States would receive the tax revenue from the U.S. company's activities. The UK's imposition of a punitive DPT, however, incentivizes the U.S. company to restructure to be subject to UK tax, so that the UK receives the tax revenue from the U.S. company instead of the United States.

## B. Digital Services Taxes (and Pillar I)

DSTs are arguably an even more overt move that a number of countries have made to tax income that treaty obligations would otherwise prevent them from reaching. DSTs, generally speaking, are taxes that a country imposes on the revenue of an enterprise earned with respect to the provision of one or more types of digital services. For example, France has a DST that imposes a 3% tax on revenue earned from the supply, through a digital interface, of a digital platform or from the supply of services to advertisers related to user data. <sup>[94]</sup> The French DST is limited to enterprises that satisfy both a global revenue threshold and domestic revenue threshold. <sup>[95]</sup> The global revenue threshold is satisfied if the enterprise generates annual global revenue of EUR 750 million or more, and the domestic revenue threshold is satisfied if the enterprise generates EUR 25 million or more in French revenue. <sup>[96]</sup> Spain's DST has similar terms as the French DST, but it applies to gross revenue from digital intermediation services, digital advertising services, and the sale of user data generated through digital interface, and it has a lower domestic revenue threshold of EUR 3 million. <sup>[97]</sup> In general, the rate, scope, and revenue thresholds vary widely between countries that have implemented DSTs. For example, Austria's DST rate is 5%, but Austria only taxes revenue from online advertising. <sup>[98]</sup> The UK imposes a 2% tax on revenue from social media platforms, Internet search engines, and online market places. <sup>[99]</sup> In some countries, DSTs are imposed on both resident and nonresident companies and are deductible for corporate income tax purposes against the income of resident companies. <sup>[100]</sup> India's DST, the equalization levy, however, is imposed only on nonresident companies. <sup>[101]</sup>

The DST concept was first introduced by the European Commission (the “EC”) as a measure specifically designed to circumvent the permanent establishment limitation. <sup>[102]</sup> Specifically, in a Communication released on September 21, 2017, the EC asserted that the permanent establishment and transfer pricing rules for taxing income were inadequate to ensure that countries receive their fair share of tax revenue from digitalized businesses. <sup>[103]</sup> The Communication indicated that a long-term solution for taxing “corporation profits” was essential, <sup>[104]</sup> and suggested short-term solutions, which included a levy on revenues generated from the provision of digital services or advertising activity. <sup>[105]</sup> Months later, the EC went on to offer two proposals. One proposal was for the long-term solution for the taxation of the digital economy, which involved the establishment of a digital permanent establishment concept, pursuant to which a country would tax profits allocable to a digital permanent establishment in that country. <sup>[106]</sup> The Communication recognized that the implementation of this proposal would require modification to international tax treaties. <sup>[107]</sup> The other proposal was an interim solution, proposing the implementation of DSTs. <sup>[108]</sup> The EC did not move forward with the proposal for the implementation of DSTs, <sup>[109]</sup> but individual countries decided to move forward on a unilateral basis.

The introduction of DSTs caused the international uproar that led to the Inclusive Framework’s adoption of the two-pillar solution to address tax challenges arising from the digitalization of the world economy. <sup>[110]</sup> Specifically, in December 2019, the U.S. Trade Representative (the “USTR”) determined that France’s DST was subject to action under Section 301 of the Trade Act of 1974 ( *i.e.*, it was unreasonable or discriminatory and burdened or restricted U.S. commerce), discriminated against U.S. digital companies, was inconsistent with principles of international taxation, and burdened U.S. companies. <sup>[111]</sup> In January 2021, the USTR determined that the same was true with respect to the DSTs adopted by Austria, India, Italy, Spain, Turkey, and the UK. In March of that year, the USTR announced proposed trade actions against the offending countries. <sup>[112]</sup> The United States backed down from taking Section 301 action on October 8, 2021, when the Inclusive Framework reached an agreement on the two-pillar solution. <sup>[113]</sup> Countries with DSTs on the books won out substantially from this deal. <sup>[114]</sup> Countries with DSTs already in effect agreed to withdraw their DSTs upon the implementation of Pillar I and to credit DSTs charged before the implementation of Pillar I against future Pillar I liability. <sup>[115]</sup> The two-pillar solution placed a moratorium on the introduction of new DSTs until the end of 2023, so Inclusive Framework countries poised to implement DSTs needed to hold off. <sup>[116]</sup> Recently, the moratorium was extended to the end of 2024, with the possibility of being further extended to the end of 2025. <sup>[117]</sup> Canada did not approve the extension of the moratorium, <sup>[118]</sup> and indicated that it plans to move forward with the implementation of its DST. <sup>[119]</sup> Canada reasonably pointed out the inequity between countries that had pre-existing DSTs and who have been collecting on them for years and countries, like Canada, who have been forced to wait to implement their DSTs. <sup>[120]</sup>

Pillar I, oddly enough, in the form it has taken has very little to do with DSTs, other than the fact that countries have agreed to withdraw their DSTs upon the adoption of Pillar I. The specific part of Pillar I that relates somewhat to DSTs is Amount A. Originally, in the October 2020 Pillar I Blueprint, the OECD planned that Amount A would only apply to multinational groups providing automated digital services or that had consumer facing businesses. <sup>[121]</sup> That limitation was removed, and Amount A now would apply to all “Covered Groups,” which generally are “Groups” <sup>[122]</sup> with revenue in excess of EUR 20 billion and with pre-tax profit margins in excess of 10%. <sup>[123]</sup> Amount A calls for the reallocation of a portion of the profits of a Covered Group by applying formulary apportionment. In general terms, such apportionment would be undertaken as follows.

- 1) The Covered Group sources its revenue between jurisdictions based on various sourcing rules that apply to different types of revenue. <sup>[124]</sup>



- 2) The Covered Group calculates its adjusted profits before tax which is the Covered Group's financial accounting profit (or loss) reported on its financial statements and then adjusted under Annex B of the Pillar I Multilateral Convention. [\[125\]](#)
- 3) The Covered Group's profits above a 10% profitability threshold are multiplied by 25%. [\[126\]](#) The product is the "Amount A Profit," which is the portion of the Covered Group's profits that are apportioned between market jurisdictions. The numerator of the apportionment fraction for each jurisdiction is the revenue sourced to the jurisdiction and the denominator is the total revenue of the Covered Group. [\[127\]](#)

The hard(er) part comes after the apportionment of Amount A Profit, when the jurisdictions from which Amount A is apportioned must be determined. [\[128\]](#) Those jurisdictions must correct for the double taxation that occurs under Amount A (when both they and the market jurisdictions to which Amount A is allocated tax the same income) either through a refund, a refundable credit, a credit, or a deduction. [\[129\]](#)

The thematic connection between Amount A and DSTs is that both reflect countries' dissatisfaction with their tax bases under the current PE Requirement. Pillar I began with digital services (in the form of DSTs), then expanded to include consumer facing businesses (under the Pillar I Blueprint), and now has expanded to reflect market jurisdictions' insistence on receiving a larger piece of the tax-base pie with respect to all large multinationals. As with the DPT, the fundamental interest, with respect to DSTs and Amount A, is not combating tax avoidance, but rather renegotiating the historical nexus compromise for source jurisdictions to access income that treaty arrangements would have otherwise allocated to residence jurisdictions and to more broadly align the determination of source with the location of the market. The interesting part of the renegotiation is that there is no concession to residence countries on the permanent establishment side, but that makes sense for two reasons. First, Pillar I mixes concepts of source, with Covered Groups determining source with respect to 75% of their profits over the profitability threshold based on relevant countries' (and their treaties') sourcing rules and sourcing their Amount A Profit by place of market. Thus, income sourced to a country may still be included in Amount A. Second, Pillar I is not necessarily principle driven due to it being a negotiated agreement between parties.

## C. Pillar II and UTPR

Finally, the Treaty Avoidance Regime most disconnected from anti-abuse and most focused on opportunities to expand countries' tax bases is UTPR, the discussion of which requires a bit of background. UTPR, in its current form, is one of two charging provisions under Pillar II that together seek to implement a world-wide 15% minimum tax through the mechanism of a jurisdiction-by-jurisdiction "Top-Up Tax." Generally, Pillar II's Top-Up Tax Rules apply to "MNE Groups" that have annual revenue of EUR 750 million or more in their consolidated financial statements. [\[130\]](#) In general, the Top-Up Tax for a jurisdiction is determined by applying the following steps outlined in the Pillar II Model Rules (also referred to as the "Global Anti-Base Erosion" or "GloBE" rules).

- 1) The MNE Group determines its "Net GloBE Income" for a jurisdiction in which it has a constituent entity. [\[131\]](#)
- 2) The MNE Group determines the "Adjusted Covered Tax" for the jurisdiction. [\[132\]](#)
- 3) The MNE Group computes the jurisdiction's "Effective Tax Rate," which is the percentage determined by dividing Covered Tax by Net GloBE Income. [\[133\]](#)
- 4) The MNE Group computes the jurisdiction's "Top-Up Tax Percentage," which is 15% minus the jurisdiction's Effective Tax Rate. [\[134\]](#)
- 5) The MNE Group computes the jurisdiction's "Excess Profit," which is the jurisdiction's Net GloBE Income minus the "Substance-based Income Exclusion." [\[135\]](#)
- 6) Finally, the jurisdiction's Top-Up Tax is computed by multiplying the Top-Up Tax Percentage by Excess Profit. [\[136\]](#)

The Pillar II Model Rules and the subsequent commentary and guidance modifying those rules are highly complex, with much of the complexity arising with respect to the determination of Net GloBE Income and Covered Tax. The starting point for these two amounts, generally speaking, is the consolidated financial statements of the ultimate parent of the MNE Group, without the consolidated adjustment that eliminates intra-group transactions. <sup>[137]</sup> The Pillar II Model Rules then require an array of adjustments to determine Net GloBE Income and Covered Tax. For example, rules about intercompany financing arrangements are included to prevent shifting income or loss from one jurisdiction to another. <sup>[138]</sup> There is an arm's length adjustment for intercompany transactions executed at non-arm's length prices. <sup>[139]</sup> There are numerous adjustments to each asset's basis, preventing basis step-ups that, according to the drafters of the Pillar II Model Rules, would inappropriately reduce Net GloBE Income. <sup>[140]</sup> There are rules for allocating income from permanent establishments, flow-through entities, and controlled foreign corporations ("CFCs") to parent entities, and an array of other adjustments to translate separate entity financial accounting income into the Net GloBE Income of a constituent entity. <sup>[141]</sup> There are just as many complexities in determining a constituent entity's Covered Tax, exacerbated by the fact that deferred taxes are taken into account. <sup>[142]</sup> This requires an array of adjustments to a constituent entity's current and deferred taxes. Rules apply to determine whether certain deferred tax assets and liabilities are counted, when they are not counted, <sup>[143]</sup> to what extent they are counted, <sup>[144]</sup> and when they are initially counted but then are not counted anymore. <sup>[145]</sup>

A major point of contention currently exists over the treatment of tax credits. Initially, tax credits were treated as a reduction to tax, even if they were not so treated for the relevant financial accounting purposes, unless they were refundable credits. <sup>[146]</sup> Then, a narrow exception was introduced for nonrefundable credits acquired through tax equity investments. <sup>[147]</sup> Now, tax credits that are marketable and transferrable also do not reduce Covered Tax (and instead are treated as income). <sup>[148]</sup> There are rules for allocating Covered Taxes imposed on a parent entity to its subsidiary when the Covered Taxes are the result of income from a CFC regime. <sup>[149]</sup> Very little guidance is provided for how to make these allocations. <sup>[150]</sup>

In its current form, Pillar II has two charging provisions: an "Income Inclusion Rule," or "IIR," and a "UTPR" (not an acronym for anything). <sup>[151]</sup> A "Qualified Domestic Minimum Top-Up Tax," or "QDMTT," is a third Top-Up Tax that reduces any liability that would otherwise be imposed under an IIR or UTPR. A jurisdiction has the first opportunity to tax low-taxed income under a Top-Up Tax through the implementation of a QDMTT. If the jurisdiction has no QDMTT or the QDMTT loses its "qualified" status, then the ultimate parent entity in a jurisdiction that has implemented an IIR (or an intermediate parent entity if the ultimate parent entity has not implemented an IIR) is subject to the Top-Up Tax. Finally, if a constituent entity in a low-tax jurisdiction is not subject to an IIR, then the jurisdictions that have implemented UTPRs split the Top-Up Tax among one another, each UTPR jurisdiction imposing its share of the Top-Up tax on constituent entities in the UTPR jurisdiction.

It is important to point out that Pillar II did not start out this way and has only evolved into its current form after a number of changes were made to its original design. In the OECD's October 2020 Pillar II Blueprint (the "Pillar II Blueprint"), <sup>[152]</sup> Pillar II was described as an IIR with a UTPR "backstop." <sup>[153]</sup> There was no discussion of a QDMTT, only discussion of a domestic minimum tax using the same base as Top-Up Tax that jurisdictions could apply to deal with UTPR. <sup>[154]</sup> In the Pillar II Blueprint, "UTPR" was an acronym for "undertaxed payments rule" and it applied only to deny deductions or make "equivalent adjustments" with respect to intra-group payments. <sup>[155]</sup> A UTPR jurisdiction would be allocated a portion of the Top-Up Tax only to the extent that it had constituent entities that made deductible payments to the low-taxed constituent entities or to the extent that the jurisdiction did not have net income from intra-group payments. <sup>[156]</sup> Top-Up Tax would be allocated to UTPR jurisdictions first based on intra-company payments made to low-tax jurisdictions and then based on the relative volume of net deductions from intra-company payments. <sup>[157]</sup> In that respect, UTPR was "limited in its application to the extent of intra-group payments." <sup>[158]</sup>

After the Pillar II Blueprint came the Inclusive Framework's adoption of the two-pillar solution in the October 2021 Statement. The October 2021 Statement contained no indication that the thinking had changed. <sup>[159]</sup> It continued to refer to UTPR as the undertaxed payments rule and made no mention of a QDMTT or any manner of domestic minimum tax.

The first major shift away from the Pillar II Blueprint came soon after the release of the October 2021 Statement, upon the December 2021 release of the Pillar II Model Rules. In the Model Rules, "UTPR" was no longer the undertaxed payments rule, as the nature of UTPR had shifted dramatically. First, UTPR was no longer connected to intra-group payments, so the method for allocating Top-Up Tax between UTPR jurisdictions no longer worked. Instead, Top-Up Tax was allocated between UTPR jurisdictions on a more arbitrary basis, based on the relative amount of employees and tangible assets in each UTPR jurisdiction. <sup>[160]</sup> Thus, UTPR moved from a more targeted provision that would have prevented base erosion from intra-group payments to a stand-alone taxing right based on formulary apportionment. The apportionment formula the Pillar II Model Rules settled upon can be summarized as follows. <sup>[161]</sup>

- 1) The MNE Group determines the number of employees and the value of tangible assets in each UTPR jurisdiction.
- 2) The MNE Group divides the number of employees in a jurisdiction by total employees of the MNE Group in all UTPR jurisdictions and multiplies the resulting amount (represented as a percentage) by 50%.
- 3) The MNE Group divides the value of its tangible assets in a jurisdiction by the total value of all of its tangible assets in all UTPR jurisdictions and multiplies the resulting amount (represented as a percentage) by 50%.
- 4) The two percentages computed above are added together and the resulting percentage is the share of Top-Up Tax apportioned to the UTPR jurisdiction.

The formulary apportionment applied by the Pillar II Model Rules is different than the formulary apportionment normally applied because the items used in the fraction denominators to compute the apportionment percentages are only those items from UTPR jurisdictions. Thus, the apportionment of Top-Up Tax to a jurisdiction is not tied to the jurisdiction's contribution (or deemed contribution) to the economic activity of the enterprise as a whole. This aspect adds to the arbitrary nature of the UTPR formula, as it is just a principle-flavored method for UTPR jurisdictions to divvy up Top-Up Tax among one another.

The other significant change made in the Pillar II Model Rules was that UTPR jurisdictions would deny all deductions (or make equivalent adjustments) until the resulting increase in tax was equal to the Top-Up Tax apportioned to the jurisdiction. <sup>[162]</sup> Nevertheless, the Pillar II Model Rules still appeared to limit a UTPR jurisdiction's ability to impose Top-Up Tax to the jurisdiction's tax rate multiplied by gross income in the jurisdiction, as the only mechanism for imposing the Top-Up Tax was denying a UTPR jurisdiction taxpayer's deductions or an adjustment equivalent to the denial of deductions.

Then, in the March 2022 Commentary, <sup>[163]</sup> the mask finally came off. The Pillar II Model Rules provide that constituent entities in the UTPR jurisdiction "shall be denied a deduction (or required to make an equivalent adjustment under domestic law)." <sup>[164]</sup> The March 2022 Commentary interpreted "an equivalent adjustment under domestic law" to include an upfront tax, and jurisdictions implementing UTPR have run with this interpretation. <sup>[165]</sup> This introduced the truly novel concept of a jurisdiction imposing a tax specifically on income that is neither sourced to the jurisdiction nor income of a resident of the jurisdiction.

The application of UTPR in the Pillar II Model Rules, along with further developments provided in subsequent administrative guidance, fundamentally changed Pillar II from how it was introduced to what it has become. The administrative guidance released after the March 2022 Commentary has brought QDMTT to the forefront. The key development with respect to the QDMTT has been the introduction of the QDMTT safe harbor. <sup>[166]</sup> If a jurisdiction's QDMTT satisfies the safe harbor, the only Pillar II reporting an MNE Group is required to make

is the jurisdiction's QDMTT reporting. The MNE Group's Top-Up Tax with respect to the jurisdiction is deemed to be zero, obviating the need to undertake further calculations under the GloBE rule. <sup>[167]</sup> The QDMTT safe harbor has three requirements: the QDMTT Accounting Standard Requirement, the Consistency Standard, and the Administration Standard. <sup>[168]</sup> The QDMTT Accounting Standard Requirement and the Consistency Standard, together, essentially require that a jurisdiction compute Top-Up Tax in exact alignment with the Pillar II Model Rules, commentary, and administrative guidance. <sup>[169]</sup> The Administration Standard requires that a QDMTT jurisdiction meet the requirements of an ongoing monitoring process, which will include a review of the information collection and reporting requirements under the QDMTT to ensure that they are consistent with the equivalent requirements under GloBE rules and GloBE reporting requirements. <sup>[170]</sup> Finally, permanent review processes will be put into place to determine whether a jurisdiction's QDMTT meet the standards of the QDMTT safe harbor. <sup>[171]</sup>

From all of this, the essence of what Pillar II has become emerges: To avoid being subject to Pillar II, jurisdictions around the world must implement a minimum tax that exactly follows the GloBE rules, as they are amended and "clarified" from time to time. Jurisdictions are compelled to accept this or otherwise be subject to UTPR. The Inclusive Framework insists that this system complies with international tax treaties. The next part reviews whether UTPR and other Treaty Avoidance Regimes indeed comply with international tax treaties.

## IV. Compliance with Treaties and Federal Nexus

We refer to the regimes discussed above ( *i.e.*, the DPT, DSTs, and UTPR) as Treaty Avoidance Regimes. In this Part IV, we turn to the question: How successful are they at avoiding treaties? The treaty provisions that we focus on in this Article are the PE Requirement and treaties' non-discrimination provisions.

We also discuss whether there may be any constitutional constraints that would prevent Congress from enacting a UTPR. The DPT and DSTs do not really raise any particular constitutional concerns. Perhaps, back in the days of *Bellas Hess*, the Supreme Court may have found a tax like a DST levied on a foreign person with no physical presence in the United States to have been problematic. However, in the current state of play, it is difficult for constitutional nexus limitations to come into play with respect to any of the Treaty Avoidance Regimes. UTPR, on the other hand, as discussed below, may be problematic with respect to the application of the benefits test[s].

### A. Compliance with Treaties

Below we discuss whether the Treaty Avoidance Regimes violate the PE Requirement and the non-discrimination provision of international tax treaties.

#### 1. The PE Requirement

We discussed the PE Requirement above, but an additional analysis is necessary to determine whether the PE Requirement can be applied to a tax. Specifically, most provisions of a tax treaty, including the PE Requirement, only apply to the taxes that are covered under the treaty (a "Tax Covered"). <sup>[172]</sup> Thus, before analyzing whether a tax violates the PE Requirement, we first need to determine whether the tax is a Tax Covered. The Taxes Covered provision of the OECD Model Treaty provides:

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are in particular:

- a) (in State A):
  - b) (in State B):
4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws. [\[173\]](#)

The commentary to the OECD Model Treaty explains that, in some treaties, the parties prefer to leave out paragraphs 1 and 2, above. [\[174\]](#) For those parties, their treaties would only include paragraphs 3 and 4, with paragraph 3 providing an exhaustive list of all existing taxes that the treaty is intended to cover. [\[175\]](#) Parties deciding to leave out paragraphs 1 and 2 would appear to apply their treaties on a more limited basis. Specifically, a treaty that leaves out paragraphs 1 and 2 would appear to limit itself to: (i) the specific taxes enumerated in the Taxes Covered provision ( *i.e.*, paragraph 3), and (ii) subsequently enacted taxes only to the extent that such taxes are substantially similar to the enumerated taxes (a “Substantially Similar Limitation”). A treaty that includes paragraphs 1 and 2 would appear to have broader coverage, applying to any new taxes on income and components of income, whether the tax is substantially similar to a tax listed in paragraph 3 or not (an “All Income Tax Limitation”). The current U.S. Model Treaty takes an All Income Tax Limitation approach, but the prior U.S. Model Treaty took a Substantially Similar Limitation approach. Different approaches are reflected in different U.S. tax treaties. For example, the United States-UK Treaty and the United States-France Treaty take an All Income Tax Limitation approach, while the United States-Netherlands Treaty takes a Substantially Similar Limitation approach. [\[176\]](#)

The Avoidance of PE Rule of the DPT appears to easily qualify as a Tax Covered, whether a treaty’s Tax Covered provision applies an All Income Tax Limitation or a Substantially Similar Limitation. Other than the few cosmetic differences that render it a harsher tax than the UK corporation tax, it appears to be a clone of the UK corporation tax that applies specifically in contradiction to the UK’s treaty agreements not to tax business income absent a permanent establishment. However, according to the UK itself, it is not so clear. It is possible to understand the Substantially Similar Limitation to be extremely narrow and to generally permit treaty partners to easily avoid their treaty obligations by implementing income taxes slightly different from those enumerated in the relevant treaty. For example, in *Bricom Holdings Ltd. v. Commissioners of the Inland Revenue*, [\[177\]](#) the UK Court of Appeal considered whether the UK’s CFC tax imposed on a UK shareholder with respect to the income of the CFC was substantially similar to its corporation tax. The court concluded that the CFC tax was not substantially similar because it was imposed on a notional amount of income, the income earned by the CFC, and not on an actual amount of income earned by the UK shareholder. One, of course, could take issue with the court as to whether a CFC tax is really imposed on a notional amount of income or whether it is imposed on income earned by a shareholder indirectly. However, the important point derived from the case is that the court appeared to view “substantially similar” to mean “virtually identical.” Perhaps the *Bricom* court would agree that since, technically, the Avoidance of PE Rule applies to a notional amount of income, such notional amount being the income of the foreign company would be attributable to a UK permanent establishment if such a permanent establishment existed. The argument is a bit more difficult in the DPT context because the foreign company directly earns income and is subject to UK tax on the income. In any case, outside of an extraordinarily narrow interpretation of “substantially similar” and for treaties that have an All Income Tax Limitation, the Avoidance of PE Rule appears to violate the PE Requirement in a very specific and direct way, taxing a nonresident who has no UK permanent establishment as though the nonresident has a permanent establishment.

DSTs are a bit trickier. On one hand, one could make the argument that a DST, being more in the nature of a consumption tax, is like a sales tax or VAT rather than an income tax. [\[178\]](#) In that case, neither treaties with a Substantially Similar Limitation nor treaties with an All Income Tax Limitation would prohibit a source jurisdiction from imposing a DST. On the other hand, if a DST is an income tax, there would be strong arguments that both treaties with a Substantially Similar Limitation and treaties with an All Income Tax Limitation would prohibit a



source jurisdiction from imposing a DST. The USTR has expressed the view in several reports (the “USTR DST Reports”) that DSTs are not a consumption tax, as consumption taxes are “transaction-based taxes,” and DSTs are taxes on a portion of a taxpayer’s revenue relative to the volume of the taxpayer’s relevant type of activities in the country imposing DST. [\[179\]](#) Others have argued that taxes on revenue are consumption taxes and, therefore, DSTs are consumption taxes. [\[180\]](#) Such an approach distinguishes taxes on individual items of gross income, such as gross dividends, interest, royalties, *etc.*, which are explicitly dealt with in treaties, from a broader tax on revenue. [\[181\]](#)

From our point of view, it is difficult to follow the reasoning of this distinction. First, if a tax imposed on a taxpayer’s revenue is a consumption tax that is not a Tax Covered, why would a withholding tax on a payment of rent not be a consumption tax? The item consumed in that case is the use of the rental property, and the tax is imposed on the amount paid for the item consumed by the payor. Second, the idea that a revenue tax is a consumption tax holds up, for example, in the context of sales revenue because taxing the taxpayer’s revenue is the same as imposing a discrete ad valorem tax on each of the taxpayer’s sales. For example, if Country X imposes a 1% sales tax on consumer sales and a taxpayer makes 100 sales in Country X for \$100 each, the taxpayer would be obligated to pay \$1 of tax on each sale, for a total of \$100. The tax would also be \$100 if, instead of a sales tax, Country X imposed a \$1 turnover tax on the taxpayer’s consumer sales revenue. Thus, the “turnover tax” is arguably a transaction-based tax because it is just a different way of imposing a 1% ad valorem tax on each of the taxpayer’s sales. Compare this to a circumstance in which a company provides free email accounts to 100 users in Country X, collects data from the users, compiles it with the data of a worldwide group of 1000 users, analyzes the data, and sells the analysis for \$1000. Country X determines that 10% of the company’s digital services revenue, \$100, is related to Country X (because there are 100 Country X users out of a total of 1000 users) and imposes a \$3 (3%) tax on such revenue. This is not the equivalent of imposing a 3% ad valorem tax on the company’s provision of email accounts to the 100 Country X users. First, there is no indication that each Country X user would be willing to pay \$1 or anything at all for the email service. Second, the revenue from the company’s sale of the collected and processed data is not a proxy for the value of the “transactions” between the company and its users because the company collects raw data from users. Third, the party paying for the compiled user data may not value the data from the 100 Country X users as much as it values the data from the users from other countries. The distinctions go on, but the point that hopefully comes across is that a high level of complex economic analysis is necessary to explain how a DST is a tax on consumption and, even with such creative analysis, it is difficult to explain how a DST is a tax on consumption. The much more straight forward analysis is that a DST is a tax on a component of income (revenue), similar to a withholding tax on rents or royalties, where the component of income is sourced to a jurisdiction based on a criteria like the proportion of users in the taxing country.

In any case, it may make no difference whether a DST is a Tax Covered. As noted above, the USTR DST Reports asserted that DSTs are not consumption taxes. However, the USTR also did not assert that DSTs violated treaty obligations. In the USTR DST Reports, the USTR consistently maintained that the PE Requirement applies to the taxation of “business profits” only and does not address taxes on gross revenue. [\[182\]](#) Following through with this approach, the USTR DST Reports did not claim that U.S. treaty partners imposing DSTs do so in violation of their treaty obligations. Instead, the USTR DST Reports argued that taxes on gross business revenue are not addressed in treaties because it is generally understood that gross revenue taxes are an inappropriate approach to taxing business income. [\[183\]](#) The EC appeared to agree with this view, as it viewed DSTs as an interim measure, merely a substitute for taxing the profits of digital businesses that would be replaced by a modified definition of permanent establishment for digital businesses. The fact that countries agreed to replace DSTs with a modified income tax under Pillar I also reflects the concession that DSTs violate norms of taxation. In sum, if DSTs are not Taxes Covered by treaties, that is because they were designed to circumvent treaty obligations by deviating from the established norms for taxing international businesses.

This is a theme that then carries us forward to UTPR, where the strategy to avoid a conflict with treaty obligations is to impose a tax that so deeply undermines the fundamental principles upon which treaties are based that

is arguably not addressed by treaties. Per its design, UTPR is a tax on income. The amount of the tax is determined by computing the income of constituent entities in a jurisdiction and then imposing a tax on the income. Commentators have noted that UTPR is different from an income tax because income taxes are imposed on the person who has the income and UTPR is not. <sup>[184]</sup> As a result, it is possible to argue that UTPR is not an income tax because a jurisdiction's entitlement to tax income arises only when the income is sourced to the jurisdiction or when the income is the income of a resident of the jurisdiction. <sup>[185]</sup> Because the jurisdiction imposing UTPR has no claim to tax the income of its constituent entity on either a source or residence basis, UTPR, is not an income tax. <sup>[186]</sup> This argument appropriately distinguishes UTPR from a CFC tax. A CFC tax is imposed on the income of a shareholder of a CFC that the shareholder earns indirectly through the CFC. <sup>[187]</sup> In the context of UTPR, the jurisdiction imposing the tax has no basis upon which to tax the income that UTPR is designed to tax. Thus, UTPR cannot be an income tax. This argument relies on respecting a UTPR jurisdiction's assertion that the Top-Up Tax it seeks to impose under its UTPR is a tax on the constituent entity upon which the tax is imposed.

A less formalistic analysis of UTPR could take the view that UTPR is a tax on the income of constituent entities in a low-tax jurisdiction, which is conveniently imposed on an entity in a UTPR jurisdiction. This view is supported by the justification for imposing UTPR in the first place. <sup>[188]</sup> It is explained that UTPR jurisdictions have the right to impose UTPR on resident constituent entities of an MNE Group because the MNE Group's constituent entities in the UTPR jurisdiction and its constituent entities in low-tax jurisdictions are part of the same economic unit. <sup>[189]</sup> If UTPR computes a tax on the basis of the income of one group of entities that are part of the same economic unit and imposes the tax on another group in the same economic unit, it stands to reason that, in substance, the tax is on the income of the economic unit (earned in the low-tax jurisdiction) and imposed on the economic unit, which would resemble a tax on income. Ultimately, the question is: Would a treaty analysis respect a taxing jurisdiction's artificial shifting of the liability for an income tax from one person to another, when the taxing jurisdiction's objective in doing so is to avoid the application of the treaty? As we will see below, this question will need to be answered again if we conclude that UTPR is a Tax Covered.

Taking the approach that UTPR is a tax on income that is a Tax Covered, the next question is whether its imposition is prohibited by the PE Requirement. For this portion of the analysis, we distinguish two circumstances. In one circumstance, a corporate head office in a low-tax jurisdiction operates through a permanent establishment in a UTPR jurisdiction. In the other circumstance, a corporate parent in a low-tax jurisdiction owns a corporate subsidiary in a UTPR jurisdiction. In each circumstance, a treaty is in force between the low-tax jurisdiction and the UTPR jurisdiction.

In the first circumstance, the UTPR jurisdiction imposes a tax on the income of the head office that is not earned in the UTPR jurisdiction. This is explicitly prohibited by the PE Requirement. The PE Requirement provides that when a nonresident has a permanent establishment in a jurisdiction, the jurisdiction's right to tax the income of the nonresident is limited to the income associated with the permanent establishment. It is difficult to see any argument that application of UTPR in this instance would comply with the UTPR jurisdiction's treaty obligations.

In the second circumstance, the UTPR jurisdiction taxes a resident corporate subsidiary and can argue that the PE Requirement is inapplicable under the saving clause, discussed above. The corporate parent would argue that it does not have a permanent establishment in the UTPR jurisdiction and, therefore, the UTPR jurisdiction is prevented from imposing UTPR on the corporate parent's business income. The UTPR jurisdiction would respond that it is permitted to impose a tax on the business income of the corporate parent because the tax is imposed on a resident of the UTPR jurisdiction and, under the saving clause, the PE Requirement does not apply to taxes that a jurisdiction imposes on its own residents. Such an assertion again would raise the question: Can a party to a treaty circumvent its commitment not to tax the income of one person by imposing liability for the tax on a different person?

This question arose in the context of India's dividend distribution tax (the "DDT") that was abolished in 2020. The DDT was a tax imposed on an Indian corporation with respect to dividends distributed to shareholders. India's

tax authority took the position that the treaty rates on dividends did not apply to the DDT because the DDT was a tax on the distributing corporation, not on the shareholder receiving the dividend. The issue went back and forth in the Indian courts. Some courts were of the opinion that the DDT was a tax on dividends, and it did not matter whether liability for the tax fell on the distributing corporation or the shareholder. <sup>[190]</sup> Since the tax was a tax on dividends and not a tax on the profits of the distributing corporation, treaty rates applied. Other courts disagreed, finding the fact that the DDT was a tax on the Indian corporation meant that treaty provisions were irrelevant, explaining:

When the taxes are paid by the resident of India, in respect of its own liability in India, such taxation in India, in our considered view, cannot be protected or influenced by a tax treaty provision, unless a specific provision exists in the related tax treaty enabling extension of the treaty protection. Taxation is a sovereign power of the State-collection and imposition of taxes are sovereign functions. Double Taxation Avoidance Agreement [(“DTAA”)] is in the nature of self-imposed limitations of a State’s inherent right to tax, and these DTAA’s divide tax sources, taxable objects amongst themselves. Inherent in the self-imposed restrictions imposed by the DTAA is the fact that outside of the limitations imposed by the DTAA, the State is free to levy taxes as per its own policy choices. The dividend distribution tax, not being a tax paid by or on behalf of a resident of treaty partner jurisdiction, cannot thus be curtailed by a tax treaty provision. <sup>[191]</sup>

Although carefully parsing these cases requires expertise in Indian tax law that this author does not in any way possess, the general controversy between Indian courts on their approaches to the interaction between treaties and the DDT appears to resonate in the UTPR context. A UTPR jurisdiction imposes a tax on a resident with respect to the income of a nonresident. One approach to the treaty analysis is that the UTPR jurisdiction has the sovereign right to tax its own residents without limitation and the analysis stops there. Nothing stops the UTPR jurisdiction from taxing the resident subsidiary. A different approach to the treaty analysis is that substance should play more of a role and that treaty obligations cannot be so easily circumvented by imposing a tax on the income of a nonresident on a resident. These two views can be understood as taking two different approaches to the saving clause. One interpretation is that the saving clause is a treaty’s express articulation of the principle explained in the language of the Indian court quoted above. Specifically, treaties generally place no limit on a jurisdiction’s right to tax its own residents. Treaties only impose limited obligations on resident countries, for example, to ameliorate double taxation and not impose discriminatory taxes. Thus, a country can shift the liability with respect to a tax from a nonresident to a resident and thereby avoid its treaty obligations. The alternative view would be that a saving clause means that treaties do not limit a country’s ability to impose tax on the basis of residence. Granting that there are only two justifications for imposing an income tax, source and residence, treaties place a limit on a jurisdiction’s right to tax on the basis of source and no limit on a jurisdiction’s right to tax on the basis of residence. Thus, residence jurisdictions generally are permitted to tax all income of their residents, as long as the residence jurisdiction, for example, ameliorates double taxation ( e.g., through an exclusion or tax credit) and does not impose discriminatory taxes.

There are loopholes in treaties through which Treaty Avoidance Regimes may pass. For each Treaty Avoidance Regime, the jurisdiction imposing the tax will argue that the tax is not a Tax Covered. Then, with respect to DSTs and UTPR, the taxing jurisdiction will have additional arguments to claim that the PE Requirement does not apply. For DSTs, taxing jurisdictions would likely argue that DSTs are not a tax on profits and so they are not covered under the PE Requirement. With respect to UTPR, taxing jurisdictions would have a difficult time arguing that the PE Requirement does not apply when Top-Up Tax is imposed on a permanent establishment of a nonresident. If UTPR is imposed on a resident of the taxing jurisdiction, the saving clause may prevent the PE Requirement from applying, with the question generally being whether the saving clause is a loophole for countries to circumvent their treaty commitments by imposing on a resident the liability for a tax on a nonresident.

## 2. Non-Discrimination

Treaties' non-discrimination provisions apply to all taxes imposed by the parties to the treaty, whether the taxes are Taxes Covered or not. <sup>[192]</sup> Three non-discrimination provisions that are potentially relevant to the Treaty Avoidance Regimes are the nationality paragraph, the permanent establishment paragraph, and the ownership paragraph. <sup>[193]</sup> The nationality paragraph is potentially relevant to each of the Treaty Avoidance Regimes, but as commentators have pointed out, <sup>[194]</sup> it has limited practical effect. The permanent establishment paragraph and the ownership paragraph are only relevant to UTPR and seem, by design, to prevent treaty jurisdictions from applying laws like UTPR to nonresidents and their subsidiaries.

### a. The Nationality Paragraph

The prohibition against discrimination under the nationality paragraph is violated if a country subjects a foreign national to more burdensome taxation (or taxation-related requirements) than a domestic national "in the same circumstances." The "same circumstances" caveat provides a relatively expansive limitation to the application of the nationality paragraph. <sup>[195]</sup> That is because the same circumstances limitation takes into account the circumstances of the protected person. Thus, for example, if the protected person is a nonresident, that person is in different circumstances than a person who is a resident. <sup>[196]</sup> As a result, the nationality paragraph generally does not prevent jurisdictions from taxing nonresidents more harshly than residents. <sup>[197]</sup> Similarly, the U.S. Model Treaty expressly distinguishes the circumstances of U.S. nationals, who are subject to taxation on their worldwide income, from the circumstances of foreign nationals who are not. <sup>[198]</sup> The principle this reflects is that the tax circumstances of a protected person are relevant to determine whether protection under the nationality paragraph is available.

For this reason, the same circumstances caveat renders the nationality paragraph inapplicable in most situations involving the taxation of business entities, as the distinction between the ways that foreign and domestic entities are taxed almost always depends on residence. <sup>[199]</sup> Nevertheless, when the disparate treatment of domestic and foreign nationals is not relevant to a circumstance, such as residence, the difference in such circumstance between the domestic and foreign nationals does not trigger the same circumstances limitation. <sup>[200]</sup>

Because of the very limited applicability of the nationality provision, especially in the context of business entities, it seems unlikely that it could apply to challenge any of the Treaty Avoidance Regimes. Countries with DSTs generally apply their DSTs both to residents and nonresidents, rendering this issue of discrimination potentially moot from the outset. India, we have noted, applies its DST-equivalent taxes only to nonresidents, but, because residents and nonresidents are not "in the same circumstances," protection under the nationality provision is generally not available.

The DPT expressly targets nonresidents and thus will often cause a difference in treatment between UK nationals and non-UK nationals. Again, though, such disparate treatment generally would not seem to provide grounds for relief under the nationality paragraph because nonresidents are not "in the same circumstances" as residents.

The nationality paragraph also likely does not provide protection against UTPR, but the reason bears elaboration. A country that enacts UTPR is saying that a nonresident can come to the country to do business through a permanent establishment or a resident company, but, if the nonresident does, the country will subject the permanent establishment or resident company to a higher tax burden if the country thinks the nonresident does not pay enough tax. UTPR expressly targets specific jurisdictions. For example, a U.S. jurisdictional Top-Up Tax that is imposed on a permanent establishment of a U.S. company operating in a UTPR jurisdiction can be viewed as a tax targeting U.S. nationals. However, a UTPR jurisdiction could respond that it only targets U.S. nationals to the extent that U.S. nationals are subject to lower tax rates than nationals of the UTPR jurisdiction. Thus, U.S. nationals and UTPR-jurisdiction nationals are not in the "same circumstances."

## **b. The Permanent Establishment and Ownership Paragraphs**

UTPR would appear to run into conflict with the permanent establishment paragraph and the ownership paragraph. That is principally because, unlike the nationality paragraph, these two paragraphs do not take into consideration the circumstances of the protected person ( *i.e.*, the nonresident), instead they only take into consideration the circumstances of the permanent establishment or resident company.

The prohibition against discrimination under the permanent establishment paragraph is violated if a jurisdiction levies a tax on the permanent establishment of a nonresident less favorably as compared to a business carried on by a resident of the jurisdiction “carrying on the same activities.” <sup>[201]</sup> This provision calls for a comparison between the tax levied on the permanent establishment and the tax that would be levied on a local business. The circumstances of the protected nonresident are irrelevant. Thus, if a jurisdiction levies an extra tax on a permanent establishment of nonresident because the jurisdiction believes that the nonresident is undertaxed, such a tax would appear to be discriminatory under the permanent establishment paragraph.

Consider, for example, USP, a U.S. corporation, that operates PE, a permanent establishment in the Netherlands. The Netherlands has adopted Pillar II and the United States has not. The Netherlands imposes on PE: (i) \$20 of tax with respect to the profits of PE, and (ii) \$100 of Top-Up Tax with respect to the undertaxed income of USP. If USP were a resident of the Netherlands carrying on the same business, USP would have been subject to only \$20 of Dutch tax, not \$120. As noted above, the circumstances of USP, the protected nonresident, are not relevant in determining whether there is discrimination, as the comparison that the permanent establishment paragraph calls for is between the tax on the permanent establishment and the tax that would be imposed on the business of a resident that has the same characteristics as the permanent establishment. Thus, the fact that the Netherlands views USP as having undertaxed profits in the United States does not make the imposition of a \$100 tax on PE nondiscriminatory. Furthermore, although a resident of the Netherlands ( *e.g.*, a Netherlands corporation) also can be subject to UTPR, the comparison called for by the permanent establishment paragraph is between a nonresident operating a permanent establishment and a resident operating a local business, not between a nonresident operating a permanent establishment and a nonresident who owns a resident operating a local business. <sup>[202]</sup> Thus, UTPR appears to result in discriminatory tax treatment, as the Netherlands imposes harsher treatment on a nonresident permanent establishment than on a resident business.

Essentially the same analysis would appear to apply with respect to the ownership paragraph. The prohibition against discrimination under the ownership paragraph is violated if a jurisdiction subjects a resident enterprise ( *e.g.*, a domestic corporation) that is owned, directly or indirectly, by a nonresident to more burdensome taxation as compared to “other similar enterprises” that are residents of the jurisdiction. <sup>[203]</sup> Here again, the situation of the nonresident is irrelevant. As a result, an extra tax that a jurisdiction would impose on a domestic corporation owned by nonresident, because the jurisdiction believes that the nonresident is undertaxed, would appear to be discriminatory. Consider the same example as the one above, except that USP owns all of the stock of Dutch BV. Here, the analysis calls for a comparison between the tax imposed on Dutch BV and the tax that would be imposed on Dutch BV if it were owned by a Dutch resident. <sup>[204]</sup> The Netherlands imposed \$120 of tax on Dutch BV, but would have only imposed \$20 if Dutch BV was owned by a Dutch resident. Thus, UTPR appears to result in discriminatory tax treatment connected to USP’s ownership.

It should be noted that, in the view of the United States, a tax provision is not discriminatory under the permanent establishment and the ownership paragraphs when there are differences in the taxation of nonresident-owned businesses for reasons that are germane to the ability of the United States to tax the permanent establishment or resident company. The Technical Explanation to the U.S. Model Treaty explains the reference to “same activities,” with respect to the permanent establishment paragraph, and “similar enterprises,” with respect to the ownership paragraph, mean that there is no discrimination when the difference in treatment is “directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared.” <sup>[205]</sup> In this context, a “tax-relevant difference in the situations” refers to a difference in the situations with respect to



a jurisdiction's ability to impose or collect tax that necessitates different treatment between two taxpayers who otherwise are treated the same. <sup>[206]</sup> This principle is reflected in three examples discussed in the Technical Explanation.

First, the Technical Explanation provides that [Code Sec. 1446](#) of the Internal Revenue Code of 1986, as amended, (the "Code") withholding is not discriminatory. <sup>[207]</sup> [Code Sec. 1446](#) applies when a partnership has income that is effectively connected to the conduct of a U.S. trade or business. <sup>[208]</sup> The provision requires that the partnership withhold on payments to foreign partners. <sup>[209]</sup> To the extent the amount withheld is higher than the tax owed by the foreign partner, the partner is refunded the difference when the partner files his U.S. federal income tax return. <sup>[210]</sup> Withholding places a greater burden on the foreign person, but it is permissible because a domestic partner is easier to collect from than a foreign partner. The relative difficulty in collecting from a foreign partner versus a domestic partner means that the foreign partner and the domestic partner are not similarly situated with respect to the ease of collection. Withholding, which eases collection, applied to a foreign partner and not a domestic partner thus is not discriminatory.

The next example involves a domestic subsidiary that either makes a liquidating distribution to a parent corporation or distributes a controlled subsidiary to a shareholder. A domestic corporation generally does not recognize gain on a liquidating distribution to its domestic parent, under [Code Sec. 337](#), or on a distribution of a controlled subsidiary to its domestic shareholder, under [Code Sec. 355](#). When the distribution is to a foreign parent or shareholder, the domestic distributing corporation is required to recognize gain under [Code Sec. 367\(e\)](#). Taxing a domestic corporation on a distribution to its foreign shareholder, but not on a distribution to its domestic shareholder, places a greater tax burden on domestic corporations owned by foreign shareholders. The Technical Explanation provides that this outcome is not discriminatory because "a foreign-owned corporation is not similar to a domestically-owned corporation." <sup>[211]</sup> In other words, with respect to nonrecognition treatment, a domestic corporation's distribution to its domestic shareholder is different from a domestic corporation's distribution to its foreign shareholder. When a domestic corporation distributes property to a domestic shareholder, a subsequent disposition of the property can still be taxed by the United States. Thus, the United States does not forfeit the right to tax the built-in gain with respect to the distributed property by granting nonrecognition treatment to the distribution. This treatment means that a foreign-owned corporation is not similarly situated to a domestically-owned corporation with respect to the continuing ability of the United States to tax subsequent gain recognized with respect to distributed property. As a result, taxing the gain when the distribution is to a foreign shareholder and not to a domestic shareholder is not discriminatory.

The Technical Explanation's last example discusses S corporation elections, which are available for domestic corporations that are owned by U.S. individuals, but are not available when a domestic corporation is owned by foreign individuals. When a corporation makes an S corporation election, the corporation becomes a flow-through and is generally not subject to tax. Domestic corporations owned by foreign shareholders thus can be subject to a greater tax burden because they cannot elect not to become pass-through entities. The Technical Explanation explains that the difference in treatment is not discriminatory because items that flow through to a domestic shareholder are taxed on a net basis that takes into account all of the items of the shareholder, while a foreign shareholder generally is not subject to U.S. tax on a net basis. S corporation mechanics are designed for the flow-through of items to net basis taxpayers and, as a result, a domestic shareholder and a foreign shareholder are not similarly situated with respect to S corporation flow-through mechanics. Therefore, permitting S corporation elections when the corporation's shareholders are net basis taxpayers and not permitting S corporation elections when the corporation's shareholders are not net basis taxpayers is not discriminatory.

As reflected in the above examples, the circumstances of a nonresident cannot be used to claim that its permanent establishment or domestic corporation are not similarly situated to a relevant U.S. enterprise. If the nonresident's circumstances could be taken into consideration, the above examples could have simply concluded that there is no discrimination because: (a) the nonresident is not subject to tax on its worldwide income, and (b) the person to whom the nonresident is compared, a domestic person operating a U.S. business

or owning a U.S. corporation, is subject to tax on its worldwide income. Under the nationality paragraph, that is a valid distinction because the nationality paragraph calls for a comparison between the circumstances of the protected person, a foreign national, and another person, a domestic national. The permanent establishment paragraph and the ownership paragraph call for a comparison between the circumstances of the permanent establishment or domestic corporation of the protected person and a business or domestic corporation that is not foreign owned. In that respect, having a foreign owner, in the Technical Explanation's view, may give rise to a dissimilar circumstance for the permanent establishment or domestic corporation as: (i) it may be more difficult for the IRS to impose a tax on amounts distributed to a foreign owner, (ii) a distribution of property may be made outside of the United States' jurisdiction to tax when distributed to a foreign owner, or (iii) flow-through mechanics of a particular U.S. tax regime may not align with the way the foreign owner is subject to U.S. tax. All of these factors can, and should, be tied to the circumstances of the permanent establishment or domestic corporation, not to the circumstances of a nonresident owner. Under UTPR, a jurisdiction would impose a tax on a permanent establishment or domestic corporation based on the circumstances of its nonresident owner, specifically, when such nonresident owner is low-taxed. Such a tax imposed based on the circumstances of a permanent establishment or domestic corporation's owners appears to be exactly what the permanent establishment and ownership paragraphs seek to prohibit.

## B. Compliance with Federal Nexus

As discussed above, each State is limited under both the Due Process Clause and the Commerce Clause to taxing income that is sourced to such State. <sup>[212]</sup> Of course, any limitation of State power under the Commerce Clause does not apply to the Federal government, as the limitation on State power under the Commerce Clause is the implication from the Clause that the power to regulate interstate and international commerce is a power of the Federal government, not of State governments. However, the Federal government is bound by the Due Process Clause of the Fifth Amendment. The Due Process Clause of the Fifth Amendment applies to the Federal government, and the Due Process Clause of Fourteenth Amendment applies to State governments—both of which prohibit depriving any person of life, liberty, or property, without due process of law. However, case law from the early 1900s established that the Due Process Clause of the Fifth Amendment does not constrain the Federal government's taxing power the way the Due Process Clause of the Fourteenth Amendment constrains State governments' taxing powers. These decisions laid the groundwork for the Federal government to establish a system of worldwide taxation on citizens and permanent residents, taxing their incomes from sources both domestic and foreign. As discussed below, this does not mean that the benefits requirement of the Due Process Clause of the Fifth Amendment does not apply, but it does leave unclear to what extent the benefits requirement has any teeth.

The issue of the Federal government's right to tax foreign-source income arose in 1909, when Congress imposed an excise tax on U.S. citizens with respect to the use of foreign-built yachts. <sup>[213]</sup> The first Supreme Court case challenging the tax, *Billings v. United States*, <sup>[214]</sup> concerned a U.S. citizen who was domiciled in the United States. In *Billings*, the taxpayer attempted to argue that the tax should be invalidated under the Due Process Clause of the Fifth Amendment because it unfairly discriminated between domestic-built and foreign-built yachts. <sup>[215]</sup> The Supreme Court rejected this argument, holding that discrimination of this kind was permitted. <sup>[216]</sup>

Then, in *United States v. Bennett*, <sup>[217]</sup> a taxpayer challenged the tax when the taxpayer had used her foreign-built yacht exclusively outside of the territory of the United States. The taxpayer pointed to State tax jurisprudence to support her case. <sup>[218]</sup> Specifically, under the Due Process Clause of the Fourteenth Amendment, a State is not permitted to tax activity occurring outside of the State under the benefits requirement. <sup>[219]</sup> Applying that same standard, the taxpayer argued that the Federal government should not be permitted to tax activity that occurs solely outside of the United States. In the taxpayer's words:

It is a settled rule of constitutional law that the power to tax depends upon jurisdiction of the subject-matter of the tax. A long line of unbroken authority illustrates this firmly established doctrine in its various aspects, and although the cases have all arisen under state tax laws, their reasoning is applicable to and controlling in the case of a federal tax act. [\[220\]](#)

The taxpayer asserted that, in applying the benefits requirement, the Court had agreed that a State's assertion of tax over commerce occurring outside of its borders was a "a mere arbitrary and unwarranted burden" when "the capacity of the taxing government to afford that benefit and protection which is the true basis of the right to tax" is not present. [\[221\]](#) In rejecting the taxpayer's argument, the Court distinguished between taxes imposed by State governments and taxes imposed by the Federal government, stating:

But here again the confusion of thought consists in mistaking the scope and extent of the sovereign power of the United States as a nation, and its relation to its citizens, and their relations to it. It presumes that government does not, by its very nature, benefit the citizen and his property wherever found. Indeed, the argument, while holding on to citizenship, belittles and destroys its advantages and blessings by denying the possession by government of an essential power required to make citizenship completely beneficial. [\[222\]](#)

The distinction the Court appears to make is that benefits conferred by a State government are limited to its borders. Therefore, commerce occurring outside of a State does not benefit from the government of the State, and it would be fundamentally unfair for the State to tax such activity. The benefit of U.S. citizenship, however, applies to citizens no matter where they travel and no matter what the activities are in which they engage. As a result, there is no fundamental unfairness for the Federal government to tax the activity of a U.S. citizen, even when that activity takes place solely outside of the United States.

The Court reaffirmed this distinction in an income tax case, *Cook v. Tait*. [\[223\]](#) The case concerned a taxpayer who was a U.S. citizen who moved to Mexico and who earned income exclusively outside of the United States. [\[224\]](#) The taxpayer asserted that he should not be obligated to file U.S. income tax returns or pay tax on the income that he earned outside of the United States. [\[225\]](#) The Court discussed the distinction that it made in *Bennett* between Federal and State powers to tax, quoting the language from *Bennett* above and elaborating:

[T]he principle was declared that the government, by its very nature, benefits the citizen and his property wherever found, and therefore has the power to make the benefit complete. Or, to express it another way, the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, nor was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen. The consequence of the relations is that the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country, and the tax be legal, the government having power to impose the tax. [\[226\]](#)

In summary, the Court determined that residence-based taxation—taxing a resident of the United States on world-wide income—was legitimate. [\[227\]](#) In reaching this conclusion, the Court did not set aside the benefits requirement, but instead concluded that the benefits requirement was satisfied with respect to all income earned by a citizen of the United States. [\[228\]](#)

Taxpayers have not had success challenging Federal taxes on benefits requirement grounds. The case law has never concluded, however, that the benefits requirement does not apply under the Due Process Clause of the Fifth Amendment. In *Guarantee Trust Co. v. Commissioner*, [\[229\]](#) the executors of the will of a U.S. citizen and resident challenged the application of the U.S. estate tax to property of the decedent located in England. The executors asserted that, at the time of his death, the decedent did not benefit from the protections of the U.S. government and as such, Due Process should prevent the English property from being subject to U.S. estate tax. The Second Circuit disagreed. [\[230\]](#)

Later, in *Rexach v. United States*, [\[231\]](#) the taxpayer was a U.S. citizen who moved to the Dominican Republic and renounced his U.S. citizenship in 1958. Three years later, in 1961, the taxpayer applied for a U.S. passport, claiming that he renounced his U.S. citizenship under duress. [\[232\]](#) The taxpayer's citizenship was reinstated, but he claimed that for the years between the renouncement and reinstatement he should not have had U.S. federal income tax obligations, because he did not have access to the benefits of U.S. citizenship for those years. [\[233\]](#) Similarly here, the First Circuit disagreed. [\[234\]](#)

In *Guarantee Trust* and *Rexach*, the circuit courts clarified that the benefits requirement is not a quid pro quo test, pursuant to which a U.S. citizen must be receiving benefits from the Federal government in order for the Federal government to be able to assert taxing jurisdiction over the income and property of the citizen. Nevertheless, neither the Supreme Court nor the circuit courts concluded that the Due Process Clause of the Fifth Amendment does not impose a benefits requirement with respect to the Federal government's right to tax. In that respect, it would seem relatively clear that if Congress were to impose an income tax on a nonresident alien with respect to income earned outside the United States, the tax would be unconstitutional, as it would fail the benefits requirement imposed by the Due Process Clause of the Fifth Amendment.

If Congress imposed UTPR on U.S. resident entities and permanent establishments, the Court would not be constrained to analyze the tax as a tax specifically on the resident or permanent establishment. Instead, the Court could view the tax as one imposed on the MNE Group. As discussed above, the Court in *Container Corp.* and *Barclays* specifically concluded that Due Process did not require Congress to respect the separateness of legal entities. [\[235\]](#) Even analyzing UTPR as a tax on the MNE Group, the question is whether the tax violates the benefits requirement. The way that UTPR is determined, it seems to quite specifically violate the benefits requirement. Under the U.S. Federal income tax provisions of the Code, the Federal government already determines the amount of income of foreign-based MNE Groups that is connected with the United States and thereby taxes that income. [\[236\]](#) Then, the Federal government would apply UTPR, which is specifically designed to tax the income of the MNE Group that the Federal government has determined is not connected to the United States.

It has been suggested that UTPR is not a tax on income and instead should be viewed as an excise tax. [\[237\]](#) However, it is not clear how such treatment would render the tax constitutional. If the benefits requirement applies to Federal taxes—which the case law above suggests it does—then the subject matter of the tax needs to be connected to the United States through the subject matter's connection to the United States itself or through its connection to a U.S. citizen or resident. Whether UTPR is an income tax, the subject matter of the tax is the income of the constituent entities of an MNE Group that are tax residents of low-tax jurisdictions. Per UTPR's specific design, that subject matter has no connection to the United States itself or to a citizen or resident of the United States.

The Supreme Court could decide that the goal posts for Due Process have moved based on an international consensus to UTPR. However, based on the Court's historical application of the benefits requirement to Federal taxes, there would be grounds to challenge this position if Congress enacted UTPR.

## V. Alternative Approaches

There are alternatives to the two-pillar solution that have not been given nearly as much attention or consideration. In Part V.A, we discuss one approach that primarily would address an alternative to DSTs and would involve a renegotiation of bilateral treaties with inspiration from the UN Model Treaty. <sup>[238]</sup> Regarding Pillar II, it is difficult to find fault with an IIR approach, if we assume that a world-wide minimum tax is necessary in the first place. <sup>[239]</sup> UTPR, on the other hand, is irreconcilable with basic tax policy principles. <sup>[240]</sup> In Part V.B, we discuss UTPR's inconsistency with such principles and suggest an alternative approach to UTPR. Such an approach, at least arguably, would align with basic tax policy principles and still addresses the race-to-the-bottom and profit-shifting concerns that Pillar II was designed to solve.

## A. Source-Residence Renegotiation Approach

State tax developments discussed in Part II have illustrated that the permanent establishment threshold may no longer be an appropriate threshold for limiting a source jurisdiction's right to tax in the Digital Age. The rise of Treaty Avoidance Regimes, like the DPT and DSTs, have shown that, whether the threshold is appropriate, countries are no longer willing to accept its boundaries. An approach to these developments that we have not yet discussed is provided in the UN Model Treaty. <sup>[241]</sup>

Article 12A of the UN Model Treaty permits treaty partners to impose gross basis taxes at a negotiated rate on cross-border payments of fees for technical services. <sup>[242]</sup> Article 12B of the UN Model Treaty provides a similar, but meaningfully different, approach to cross-border income from automated digital services ("ADS"). <sup>[243]</sup> The approach with respect to ADS defaults to a gross basis tax at a negotiated rate, but also provides an alternative that the service provider can opt-into that is closer to a net basis tax. <sup>[244]</sup>

The alternative would be determined as follows: First, the service provider would compute its profitability ratio with respect to ADS. <sup>[245]</sup> For taxpayers in different circumstances, the relevant profitability ratio can be either the profitability ratio with respect to the service provider's entire business or just its ADS segment, or if the service provider is a member of a multinational group, the profitability ratio with respect to the group's business or ADS segment. <sup>[246]</sup>

Next, the nonresident service provider's profitability ratio is multiplied by the revenue derived by the service provider from ADS in the market jurisdiction imposing the tax. <sup>[247]</sup> The amount so determined acts as a rough estimate of the nonresident service provider's profits from providing the services to residents of the market jurisdiction. <sup>[248]</sup>

Finally, the nonresident service provider multiplies the above rough profit estimate by 30%, with the product referred to in the UN Model Treaty as the service provider's "qualified profits." <sup>[249]</sup> The service provider's tax is computed by multiplying its qualified profits by the relevant domestic income tax rate applied by the taxing jurisdiction. <sup>[250]</sup>

An approach along the lines of Article 12B could be suggested that applies more broadly to all services income and that applies more precise methods for measuring the profit that the market jurisdiction is entitled to tax (a "Source-Residence Renegotiation Approach"). <sup>[251]</sup> A Source-Residence Renegotiation Approach would apply to all services, not just ADS, aligning with the view that the Digital Age has obsoleted physical presence and permanent establishment not only with respect to ADS, but rather with respect to services generally. Similar to Article 12B, under a Source-Residence Renegotiation Approach, bilateral treaties would permit gross basis taxation at a negotiated rate for payments with respect to cross-border services. Also similar to Article 12B, a Source-Residence Renegotiation Approach would provide an elective alternative pursuant to which a cross-border service provider would be subject to tax on profits instead of on revenue. However, instead of using a formula like the one suggested in Article 12B, the service provider would elect to file an income tax return in the market jurisdiction. The return would show the profits from the services in the same way as a return filed with



respect to a permanent establishment in the market jurisdiction—such a return would show the profits from the services, rather than just an estimate based on general profitability.

The difficult part, then, is determining how much of the profits reported on the return in the market jurisdiction should be subject to tax. In this Part V.A, we have been referring to the jurisdiction from which the cross-border payment originates as a “market” jurisdiction rather than a “source” jurisdiction. This is because the place from which revenue originates is not necessarily the source of the revenue. For example, according to the Code, the place from which revenue originates is irrelevant in determining the source of income from services. <sup>[252]</sup> Thus, only part of the renegotiation is about whether the source or residence jurisdiction is entitled to tax the cross-border income. The other part of the renegotiation focuses on deciding how to divide the right to tax income between jurisdictions, when each jurisdiction can claim that it is the source of the income. For example, in the ADS context, the revenue to the service provider comes from residents of the market jurisdiction. However, the hardware, software development, maintenance, and management are all outside of the market jurisdiction. So here, yet again, we reach an impasse that seemingly can only be solved by formulary apportionment.

In Article 12B, the formula is incredibly simple: profit multiplied by 30%. <sup>[253]</sup> This follows along with the Pillar I approach of picking an arbitrary percentage and saying that the fractional amount should be a market jurisdiction’s cut of taxable income. Although describing an amount as arbitrary generally implies a pejorative, in the context of treaty negotiation this is not necessarily the case, as treaty rates with respect to passive-type income (dividends, interest, royalties, *etc.*) are arbitrary in the same sense. Also, the percentage being arbitrary is less offensive when, as is the case here, there is no possibility for the use of an arbitrary amount to lead to double taxation.

The Source-Residence Renegotiation Approach can be viewed as a combination of, and improvement upon, the DPT and DST regimes. This approach defaults to a DST-like approach, permitting a market jurisdiction to impose a gross basis tax on a service provider’s cross-border revenue. The Source-Residence Renegotiation Approach improves on DSTs because gross basis taxation is imposed at a negotiated rate and gross basis taxation is only a default. Of course it is also an enormous improvement over DSTs in that the residence jurisdiction would be obligated by treaty to provide a credit or exclusion to prevent double taxation.

The Source-Residence Renegotiation Approach also improves on the DPT. First, the Source-Residence Renegotiation Approach removes uncertainty over when a market jurisdiction will impose tax. Second, the Source-Residence Renegotiation Approach results in an ordinary tax, not a punitive tax. Third, and most importantly, under the Source-Residence Renegotiation Approach, a market jurisdiction would not appropriate all of the cross-border income for its own taxation when the permanent establishment threshold is not crossed. As discussed above, a key issue with the DPT is that it does not assert jurisdiction over income that otherwise would not be subject to tax. <sup>[254]</sup> It asserts jurisdiction over income that it relinquished, under a treaty, to its treaty partner. The Source-Residence Renegotiation Approach sets aside the cliff effect of “yes permanent establishment” or “no permanent establishment” deciding which party has the right to tax all of the income associated with a business operation. However, the Source-Residence Renegotiation Approach does raise questions when a nonresident service provider has a permanent establishment in a market jurisdiction. In that scenario, the residence jurisdiction relinquishes its claim to tax 100% of the income associated with the permanent establishment. That outcome does not make very much sense if we are saying that the concept of permanent establishment is obsolete. Thus, further consideration may be warranted in considering whether a market jurisdiction should relinquish some of its taxing rights with respect to income attributable to a permanent establishment in the market jurisdiction.

## B. Alternative UTPR

Running counter to any trend discounting the significance of permanent establishment is UTPR, which places more significance on permanent establishment than it ever had before. Until UTPR came along, permanent establishment was just a threshold beyond which a residence jurisdiction yielded taxing rights to a source

jurisdiction with respect to business income attributable to that source jurisdiction. According to UTPR, however, having a nonresident's permanent establishment in a country means there is sufficient connection between a country and a nonresident for the country to view the nonresident as a resident and thus have the right to tax the nonresident's income beyond the income connected to the permanent establishment and beyond the income related to the country. It is doubtful that this outcome is the result of a thoughtful policy decision that, in fact, the permanent establishment threshold is more vital and relevant than ever. More likely, it is yet another decision that was made solely on the basis of applying Pillar II as far as it could be applied. Practically, taxpayers are required to file tax returns and pay tax on their business profits in jurisdictions in which they have permanent establishments, so such returns could also be made to include GloBE returns. Furthermore, if permanent establishments were not essentially treated as resident companies under Pillar II, to avoid Pillar II, at least some enterprises could get rid of all of their entities incorporated in UTPR jurisdictions and only operate in those jurisdictions through permanent establishments.

In this way and many others, UTPR is unprincipled. As we have discussed, Pillar II denies the fundamental principles of jurisdiction to tax. <sup>[255]</sup> Such principles view source and residence as providing a jurisdiction the right to tax. If a jurisdiction is the source of income or the location of an activity or property, the jurisdiction has been viewed as having the right to tax the income, activity, or property. If a person is a resident of a jurisdiction, the jurisdiction has been viewed as having the right to tax the income, activity, or property of the resident. UTPR claims that a jurisdiction has the right to tax anyone—residents or nonresidents (permanent establishments included)—as much as it wants to tax them. UTPR is designed as a Top-Up Tax, but if we agree that a jurisdiction has the right to impose UTPR, there is no principle that limits a jurisdiction only to imposing Top-Up Tax.

There is also no real principle behind which countries are allocated rights to impose a Top-Up Tax. We noted earlier that the UTPR jurisdiction apportionment formula is based in equal parts on the number of employees and value of tangible property located in a jurisdiction. <sup>[256]</sup> As provided in the March 2022 Commentary, this apportionment is not focused on relative entitlements but is instead focused on making sure that all of the Top-Up Tax gets levied. The commentary provides:

The UTPR Percentage is determined on the basis of factors that reflect the relative substance of the MNE Group in each UTPR Jurisdiction. Relying on substance factors provides for a simple and transparent allocation key which facilitates the co-ordination among tax administrations. It is also expected that the jurisdictions where the MNE Group has more substance on a relative basis will be those where there is more tax capacity (such as deductible expenditure) to absorb adjustments under the UTPR. This approach, together with the exclusion mechanism in Article 2.6.3, is intended to reduce the risk of allocating Top-up Tax to a jurisdiction that does not have enough capacity to impose the UTPR adjustment. <sup>[257]</sup>

UTPR is very loosely apportioned based on a measurement of “substance,” which is different than how substance is measured for the Substance-based Income Exclusion, which substitutes payroll for number of employees. The March 2022 Commentary explains that payroll was considered for UTPR apportionment but rejected by the Inclusive Framework. <sup>[258]</sup> There is no explanation why the Inclusive Framework rejected payroll for UTPR apportionment. Moreover, apportionment based on “substance” has nothing to do with any judgment that high-substance jurisdictions are the most harmed by low-tax jurisdictions or the most entitled to tax. Rather, high-substance jurisdictions will be the jurisdictions with the most capacity to absorb Top-Up Tax adjustments *via* denial of deductions. Thus, the purpose behind the apportionment is generally moot, as jurisdictions imposing UTPR are not going to apply a deduction denial mechanism but instead will apply an up-front tax.

The March 2022 Commentary also mentions the exclusion mechanism in Article 2.6.3, which makes it completely clear that UTPR apportionment has nothing to do with justified entitlements. <sup>[259]</sup> Under Article 2.6.3,

a UTPR jurisdiction is essentially kicked out of UTPR for as long as it is unable to charge 100% of its Top-Up Tax. <sup>[260]</sup> So, for example, if a jurisdiction were to use a deduction denial mechanism and, in one year, there were insufficient deductions in the jurisdiction for it to deny enough to account for its apportioned Top-Up Tax, then in the following year, the jurisdiction is apportioned no Top-Up Tax. This goes on until the jurisdiction has accounted for all of its apportioned Top-Up Tax. In the meantime, the other UTPR jurisdictions collect what would have been the disallowed jurisdiction's share. It is thus no wonder that once jurisdictions were told that an up-front tax was permitted, the only option selected was an up-front tax. Otherwise, a jurisdiction would risk missing out in the annual UTPR apportionment. The ability to exclude a UTPR jurisdiction if it cannot apply UTPR makes it absolutely clear that the UTPR apportionment has nothing to do with any jurisdiction having any justified entitlement to collect UTPR.

There is also a coercive element of UTPR. The Inclusive Framework calls what is happening consensus, but it really means coercion. Very few countries outside of the European Union showed any initial enthusiasm to actually implement Pillar II as a general matter and, even now, less than one-third of the Inclusive Framework countries have proposed or enacted Pillar II legislation (IIR, UTPR, or a QDMTT). <sup>[261]</sup> Fewer than half of the Inclusive Framework countries have acknowledged that they will follow through with any Pillar II legislation. <sup>[262]</sup> It stands to reason that a number of the countries that have agreed to enact Pillar II legislation have done so as the result of the intentionally coercive UTPR regime. Furthermore, what do countries have to look forward to after embracing their duty to submit to Pillar II? Ongoing international monitoring of their administration of their Pillar II regime and ongoing peer review of compliance.

Of course, there is also the question: Does it stop with UTPR, or does UTPR open the door for jurisdictions to assert more expansive taxing rights? What happens if every jurisdiction with which an MNE Group has sufficient minimum contact has the unilateral right to decide what the entire MNE Group's effective tax rate should be? Should each new stakeholder in an MNE Group get to decide how much can be squeezed out of it before it collapses, lays off its work force, or reduces investment in tangible assets or R&D? A minimum tax of 15% may seem reasonable now, but maybe a country or a coalition of countries will decide MNE Groups still are not paying their "fair share." In that respect, it may be worth considering a UTPR that, in some cases, may not levy all the Top-Up Tax, but instead apportions taxing rights between jurisdictions in a manner that does not result in a race-to-the-bottom issue, while still connecting jurisdictions to their respective taxing rights based on principles of source and residence. Such an apportionment could work as follows:

- 1) The MNE Group would aggregate the GloBE income of all of its constituent entities ("Aggregate CE Income").
- 2) The MNE Group would source its revenue between jurisdictions based, for example, on the Pillar I rules for sourcing revenue.
- 3) The MNE Group would apportion Aggregate CE Income between jurisdictions on the basis of revenue by multiplying Aggregate CE Income (from Step 1) by a fraction, the numerator of which is the MNE Group revenue sourced to the jurisdiction and the denominator of which is all MNE Group revenue. The product, for each jurisdiction, would be the jurisdiction's "Revenue Apportioned Share."
- 4) The MNE Group would determine each high tax jurisdiction's "Base Restored Income," which would be the jurisdiction's Revenue Share minus the jurisdiction's GloBE income. Jurisdictions with Base Restored Income less than zero would not be able to charge UTPR Top-Up Tax that year.
- 5) The MNE Group would multiply the high-tax jurisdiction's Base Restored Income by its jurisdiction's Effective Tax Rate, to determine the jurisdiction's "UTPR Top-Up Tax Cap."
- 6) UTPR Top-Up Tax would be apportioned to high tax jurisdictions in proportion and subject to each high-tax jurisdiction's UTPR Top-Up Tax Cap.

The most significant improvement that such an alternative would offer is that UTPR, at least arguably, would not defy the fundamental principles of source-based and residence-based taxation. The apportionment of Top-Up Tax to a jurisdiction on the basis of the relative portion of the MNE Group's total revenue sourced to the jurisdiction and the mechanisms to prevent jurisdictions from taxing more than their revenue share would

provide a basis to support each jurisdiction's claim to its portion of Top-Up Tax (independent of Top-Up Tax mechanics). Another benefit to this approach is that it aligns with the current trends toward market-based sourcing in both the State and international tax spaces. Under the current UTPR formula, countries would face severe downsides implementing UTPRs without a coercive element because MNE Groups would be incentivized to move employees and tangible assets out of UTPR jurisdictions, the same issue that caused many States to transition from the Massachusetts Formula to a single factor sales method. A country would have no downside applying a UTPR that applies the formula above because, no matter where an MNE Group relocated profits or profit-making operations, the location of the MNE Group's market would not change. Finally, to the extent that it is true that countries with low tax rates are harming countries with high tax rates by providing an incentive to relocate profits to the low-tax jurisdiction, a UTPR based on the above formula would correct for that incentive. No matter what, every country would be entitled to tax its share of undertaxed profits based on its share of the MNE Group's market.

Of course, there are drawbacks as well. One drawback is that such a UTPR would need to include market jurisdictions in which an MNE Group may not have a resident affiliate or permanent establishment. That, however, may not be a drawback because, as we have discussed, with the exception of UTPR, the trend has been to deemphasize the importance of permanent establishments. If the issue is that UTPR countries without permanent establishments would not have taxing rights under the current treaty framework, there does not appear to be any argument that the issue applies any less if the threshold to participate in UTPR requires a permanent establishment, as discussed in Part IV.A. The other, perhaps more significant, drawback is the difficulty in settling on rules for sourcing revenue. This is admittedly a more difficult exercise than using more arbitrary factors like the number of employees and adjusted book values for tangible assets. Of course, if Pillar I Amount A actually happens, then this is not an issue at all. If Pillar I does not happen, then for folks who would like to see MNE Groups pay more tax, it may not be an issue either. Likely, countries would try to overstate their respective Revenue Apportioned Shares, which for a time would give rise to double taxation as the single factor sales apportionment method often does in the State tax space. The double taxation would provide an incentive for countries to come to the table and, if not agree to Pillar I, agree to a method for sourcing revenue.

## VI. Conclusion

To begin our discussion, we discussed the background for the League of Nations' historic compromise between source countries and residence countries around the concept of permanent establishment. A country that could claim to be the source of a taxpayer's income was viewed as having a legitimate claim to tax the income. The taxpayer's country of residence also was viewed as having a legitimate claim to the income earned by its resident. With respect to business income, nations aligned on a compromise between these competing claims. If the taxpayer did not have a physical presence in the source country rising to the level of a permanent establishment, the source country would yield its claim to tax the income. If the taxpayer had a physical presence in the source country that rose to the level of a permanent establishment, the residence country would accept the responsibility of preventing double taxation either by yielding its claim to tax the income or agreeing to provide a tax credit with respect to the tax imposed by the source country.

In the State tax space, we observed a historical focus on physical presence as the threshold for a State to claim the right to tax interstate income and the more recent shift away from that standard. The shift was connected to the rise of the Digital Age. We also observed how States have shifted towards market-based sourcing and how market-based sourcing eliminates opportunities to shift income between jurisdictions. We also discussed how WWCR was adopted by a number of States, which was an early foray by States into extraterritorial taxation.

These trends in State tax align with trends in international tax, specifically with respect to the DPT and DSTs. The DPT and DSTs are expressions of countries' dissatisfaction with the permanent establishment compromise and a greater focus on market-based sourcing. Pillar I bears a close resemblance to States' WWCR regimes, with the application of a single factor sales apportionment method to a share of the income of large multinational

corporations. Pillar I also introduces a nexus threshold that would permit market jurisdictions to participate in the Pillar I apportionment.

These trends are all one-sided, with more taxing rights being allocated to source (market) jurisdictions. The international community, however, has not been happy with the proliferation of unilateral measures and has pursued an alternative trajectory through a two-pillar solution. Pillar I, if countries accept it, raises no fundamental issues as it would only come into effect through the proposed multilateral convention. Pillar II, which would be implemented through unilateral measures, began and was advertised as a component of the two-pillar solution that worked within the current framework of international taxation and did not require any revisions to the agreements countries already had in place. We have expressed serious doubt about whether that is the case and whether, in general, countries have successfully outmaneuvered their treaty obligations with their Treaty Avoidance Regimes.

Setting that point aside, however, this Article asks, even if we can, should we? If treaties can be circumvented with measures that do not violate their provisions, but instead violate the fundamentals upon which the treaties were made, is that the right path forward? UTPR shows no concern about any theory relating to a jurisdiction's rightful entitlement to tax income. As we have discussed, UTPR spurns the fundamentals of source and residence as the basis upon which a jurisdiction can claim an entitlement to tax income. In the CFC context, the jurisdiction of a resident shareholder can claim the right to tax CFC income because the shareholder earns the income of the CFC indirectly through the CFC. The analysis is the same for partnerships and other transparent or flow-through entities. The concept of jurisdiction to tax based on residence is not that a residence jurisdiction can levy tax in any amount it wants on a resident. UTPR also runs contrary to the trend of deemphasizing the importance of permanent establishments in the Digital Age, turning them into deemed resident entities and granting a jurisdiction free rein to subject the permanent establishment's owner to any amount of tax. As can be shown from the mechanics of UTPR, it starts with the premise that an MNE Group needs to be taxed in every jurisdiction in which it operates at a jurisdictional rate of 15% percent or bear a tax burden equivalent to that outcome. Every subsequent decision, then, about how such a tax should operate is to serve that outcome.

There are other ways forward. Following a Source-Residence Renegotiation Approach, countries could revisit their treaties on a bilateral basis and renegotiate how the rights to tax services are divided between jurisdictions. Instead of beginning with the premise that every cent of Top-Up Tax much be charged, it is possible to apportion rights to collect Top-Up Tax between jurisdictions in a manner that still would prevent a perceived danger that low-tax jurisdictions pose to high-tax jurisdictions.

Concepts in tax policy and their manifestation in countries' income tax laws have provided a framework that has allowed countries to harmonize their international income tax systems since the compromise of the League of Nations nearly a century ago. Perhaps policy frameworks are obsolete in an Inclusive Framework age, when international consensus can be reevaluated and updated month-to-month. Perhaps it is not concepts like permanent establishment that are becoming become obsolete, but instead their need to have a definitive role and policy boundary is becoming obsolete. The issue to consider, though, is if constant real-time consensus ever breaks down, will any framework still exist for countries to establish mutual expectations and understanding?

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## Footnotes

- \* I would like to express my sincere gratitude to my colleagues, Julia Skubis Weber and Emily Berg, for their very significant contributions to the content, design, and presentation of this Article. I can say without hyperbole that the Article would never have come together without them and without the many hours they generously donated to this effort. I would also like to thank Josh Odintz, Paul Oosterhuis, and Bob Stack for all of their insight in developing the concepts discussed in this Article and helping to organize its presentation. In particular, I would like to thank Bob for his insights in the developing the framework for the Article's tax treaty analysis.
- 1 See, e.g., Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1026 (1997); Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001); Stephen E.



Shay, J. Clifton Fleming Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture: What's Source Got to Do with It - Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81 (2002); U.S. TREASURY DEP'T, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE, Section 7.1.5 (Nov. 1996), <https://home.treasury.gov/system/files/131/Report-Global-Electronic-Commerce-1996.pdf> [hereinafter 1996 Treasury Report].

2 Graetz & O'Hear, *supra* note 1, at 1033.

3 *Id.* at 1033–35.

4 See, e.g., Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1305–07 (1996).

5 *Id.*

6 *Id.*

7 Graetz, *supra* note 1, at 319 (noting that the permanent establishment concept “set[s] the threshold for countries to impose source-based taxation of business income”).

8 *Id.*

9 See, e.g., U.S. Model Income Tax Convention, art. 7(1) & (2), Feb. 17, 2016 [hereinafter U.S. Model Treaty]; OECD Model Tax Convention on Income and on Capital (Condensed Version), art. 7(1) & (2), Nov. 21, 2017 [hereinafter OECD Model Treaty].

10 In 1927 and 1928, Carroll was the assistant of T.S. Adams, the representative of the United States to the Committee of Technical Experts assembled by the League of Nations. Graetz & O'Hear, *supra* note 1, at 1081, 1088.

11 Mitchell B. Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad*, 2 INT'L L. 692, 700 (1968).

12 Graetz & O'Hear, *supra* note 1, at 1088.

13 *Id.* at 1107.

14 See, e.g., OECD Model Treaty, Commentaries on the Articles of the Model Tax Convention, art. 1, para. 3, cmts. 17–19 [hereinafter OECD Treaty Commentary]; 1996 Treasury Report, *supra* note 1, Sections 7.1.4 & 7.1.5.

15 See, e.g., Convention Between the United States of America and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Austria, art. 12(1), May 31, 1996, T.I.A.S. 98-201; Convention Between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Belg., art. 12(1), Nov. 27, 2006, T.I.A.S. 07-1228.2 [hereinafter Belgium Treaty]; Convention Between the Government of the United States of America and the Government of the Republic of Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Fin., art. 12(1), Sep. 21, 1989, T.I.A.S. 12101 (“Original Finland Treaty”), as amended by Protocol Amending Finland Treaty, U.S.-Fin., May 31, 2006, T.I.A.S. 07-1228.1 [hereinafter Finland Treaty]; Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Fr., art. 12(1), Aug. 31, 1994, 1963 U.N.T.S. 67 (“Original France Treaty”), as amended by Protocol to Original France Treaty Signed on December 8, 2004, U.S.-Fr., Jan. 13, 2009, T.I.A.S. 09-1223 [hereinafter France Treaty].

16 See, e.g., Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Austl., art. 12(2), Aug. 6, 1982, 35 U.S.T. 1999 (“Original Australia Treaty”), as amended by Protocol Amending Original Australia Treaty, U.S.-Austl., Sep. 27, 2001, T.I.A.S. 13164 [hereinafter Australia Treaty]; Convention Between the Government of the United States of America and the Government of the Republic of Bulgaria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Bulg., art. 12(2), Feb. 23, 2007, T.I.A.S. 08-1215.1; Convention Between the

Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-China, art. 11(2), Apr. 3, 1984, T.I.A.S. 12065 [hereinafter China Treaty]; Convention Between the Government of the United States of America and the Government of the Czech Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Czech, art. 12(2), Sept. 16, 1993, T.I.A.S.

- 17 See, e.g., Convention Between the Government of the United States of America and the Government of the State of Israel with Respect to Taxes on Income, U.S.-Isl., art. 14(1)(b), Nov. 20, 1975, T.I.A.S. (providing a 15% ceiling for patent royalties and a 10% ceiling for copyright royalties).
- 18 See, e.g., Convention Between the Government of the United States of America and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Hung., art. 10(1), Feb. 12, 1979, 30 U.S.T. 6357; Convention Between the Government of the United States of America and the Government of the Polish People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Pol., art. 12(1), Oct. 8, 1974, 28 U.S.T. 891.
- 19 See, e.g., China Treaty, *supra* note 16, art. 10(2); Convention Between the Government of the United States of America and the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Indon., art. 12(2), July 11, 1988, T.I.A.S. 11593; Convention Between the Government of the United States of America and the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Encouragement of International Trade and Investment, U.S.-S. Kor., art. 13(2), June 4, 1976, 30 U.S.T. 5253.
- 20 See, e.g., Australia Treaty, *supra* note 16, art. 11(1)–(4); Belgium Treaty, *supra* note 15, art. 11(2).
- 21 See, e.g., Australia Treaty, *supra* note 16, art. 10(1)–(3); Finland Treaty, *supra* note 15, art. 10(1)–(3).
- 22 See, e.g., OECD Model Treaty, *supra* note 9, art. 7; U.S. Model Treaty, *supra* note 9, art. 7.
- 23 Thomas S. Adams, *Interstate and International Double Taxation*, in LECTURES ON TAXATION 101, 108 (Roswell Magill ed., 1932).
- 24 U.S. Model Treaty, *supra* note 9, art. 7(2).
- 25 OECD Model Treaty, *supra* note 9, art. 7(1)–(2).
- 26 See OECD Model Treaty, *supra* note 9, art. 5(1)–(4); U.S. Model Treaty, *supra* note 9, art. 5(1)–(4).
- 27 See OECD Model Treaty, *supra* note 9, art. 5(5); U.S. Model Treaty, *supra* note 9, art. 5(5).
- 28 See OECD Model Treaty, *supra* note 9, art. 5(5); U.S. Model Treaty, *supra* note 9, art. 5(5).
- 29 See OECD Model Treaty, *supra* note 9, art. 5(6); U.S. Model Treaty, *supra* note 9, art. 5(6).
- 30 See OECD Model Treaty, *supra* note 9, art. 1(3); U.S. Model Treaty, *supra* note 9, art. 1(4).
- 31 OECD Treaty Commentary, *supra* note 14, art. 1, para. 3, cmts. 17–19.
- 32 United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, art. 1, para. 4 [hereinafter Technical Explanation].
- 33 OECD Treaty Commentary, *supra* note 14, art. 1, para. 3, cmts. 17–19; see also *id.* art. 1, cmt. 81.
- 34 See OECD Model Treaty, *supra* note 9, art. 1(3) (excluding article 23 (Relief from Double Taxation) from the saving clause); U.S. Model Treaty, *supra* note 9, art. 1(5)(a) (excluding article 23 (Relief from Double Taxation) from the saving clause).
- 35 See, e.g., OECD Model Treaty, *supra* note 9, art. 23; U.S. Model Treaty, *supra* note 9, art. 23.
- 36 [Code Sec. 901\(a\)](#) (providing a foreign tax credit for foreign income taxes); Code Sec. 903(a) (providing a foreign tax credit for taxes in lieu of income taxes); [Code Sec. 904\(a\)](#) (limiting that availability of the foreign tax credit to foreign-source income).

- 37 [Code Sec. 871](#) (limiting the taxation of a nonresident alien individual to U.S. source income, to the extent not effectively connected to a U.S. trade or business); [Code Sec. 881\(a\)](#) (same for foreign corporations); [Code Sec. 1441\(a\)](#) (limiting withholding on payments a nonresident aliens to U.S. source payments); [Code Sec. 1442\(a\)](#) (same with respect to foreign corporations).
- 38 See [Code Sec. 871](#); [Code Sec. 881\(a\)](#); [Code Sec. 1441\(a\)](#); [Code Sec. 1442](#).
- 39 [Code Sec. 871\(b\)\(1\)](#); [Code Sec. 882\(a\)](#).
- 40 43 B.T.A. 297 (1941), *non acq.* 1941-1 C.B. 18, *aff'd*, 127 F.2d 260 (5th Cir. 1942).
- 41 *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940).
- 42 *Id.*
- 43 *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2093, 2096 (2018).
- 44 *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).
- 45 386 U.S. 753 (1967).
- 46 504 U.S. 298 (1992).
- 47 *Id.* at 305.
- 48 *Id.* at 307.
- 49 *Id.* at 308.
- 50 138 S. Ct. 2080 (2018).
- 51 *Id.* at 2097.
- 52 See Richard Weiss, *MBNA America Bank : A New Standard for Nexus in Income and Franchise Taxation?*, 17 J. MULTISTATE TAX'N AND INCENTIVES 8 (Mar./Apr. 2007).
- 53 *Id.*
- 54 453 U.S. 609, 625 (1981).
- 55 *Id.*
- 56 *Id.* at 626 (quoting *Western Live Stock v. Bureau of Revenue*, 303 U.S. 240, 254 (1938)).
- 57 *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983) (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982)).
- 58 See, e.g., *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980).
- 59 John A. Swain, *Physical Presence Test Then and Now*, 102 TAX NOTES STATE, 317, 329 (Oct. 18, 2021).
- 60 254 U.S. 113 (1920).
- 61 *Moorman Mfg. Co. v. Blair*, 437 U.S. 267, 270 (1978).
- 62 See *id.* at 296.
- 63 *Id.*
- 64 437 U.S. 267 (1978).
- 65 *Id.* at 273 (quoting *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 325 (1968)).
- 66 Ara Stepanyan *et al.*, *An Empirical Economic Framework for State Corporate Tax Apportionment*, 109 TAX NOTES STATE 173, 174 (July 17, 2023).
- 67 Of \$100 of T's income, \$67 (67%) is apportioned to State X because all of T's payroll and property are in State X. Then, 50% of T's sales are in State X, causing an additional \$16.50 (16.5%) of T's income to be apportioned to State X.
- 68 463 U.S. 159 (1983).
- 69 *Id.* at 174–75.

- 70 *Id.* at 167–68.
- 71 512 U.S. 298 (1994).
- 72 *Id.* at 312 n.10 (citations omitted).
- 73 *Id.* at 303 (quoting *ASARCO Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 315 (1982)).
- 74 See, e.g., Massimo Agostini, *U.S. Perspectives of Worldwide Unitary Taxation*, 7 PENN STATE INT’L L. REV. 213, 222 (1989); James John Jurinski, *California’s Water’s-Edge Legislation: The Closing Chapter in the Unitary Tax Debate?*, 6 J. STATE TAX’N 23, 25–27 (1987); FRANCHISE TAX BOARD OF CALIFORNIA, WATER’S EDGE MANUAL, Chapter 1, Section b [hereinafter Water’s Edge Manual].
- 75 Robert Khuon Wiederstein, *California and Unitary Taxation: The Continuing Saga*, 3 IND. INT’L & COMPAR. L. REV. 135, 139 & n.24 (1992).
- 76 Agostini, *supra* note 74, at 222; Jurinski, *supra* note 74, at 26–27, 31.
- 77 See, e.g., Water’s Edge Manual, *supra* note 74, Chapter 1, Section a(1).
- 78 Legislation enacting mandatory WWCR has been introduced in Hawaii, Oregon, Minnesota, and New Hampshire. H.B. 149, 32d Leg., Reg. Sess. (Haw. 2023); S.B. 986, 32d Leg., Reg. Sess. (Haw. 2023); H.B. 2674, 82d Leg. Assemb., Reg. Sess. (Or. 2023); H.B. 2883, 93d Leg., Reg. Sess. (Minn. 2023); S.B. 1811, 93d Leg. (Minn. 2023); H.B. 1938 93d Leg. (Minn. 2023); H.B. 121, 2023 Leg., Reg. Sess. (N.H. 2023).
- 79 Instead of apportioning all of a Covered Group’s (defined below) income based on revenue, as discussed below, Pillar I would only apportion 25% of the Covered Group’s income (in excess of a routine return) a based on revenue.
- 80 Finance Act 2015, c.11, §§80-81 (UK).
- 81 *Id.* §86.
- 82 *Id.* §86(1)(c).
- 83 *Id.*
- 84 *Id.* §86(1)(e)-(f).
- 85 *Id.* §86(3).
- 86 HM REVENUE & CUSTOMS, HMRC INTERNATIONAL MANUAL, INTM489954 (2023).
- 87 Finance Act 2015, c.11, §§88(5), 89 (UK).
- 88 HM Revenue & Customs, *Corporation Tax Rates and Allowances*, GOV.UK, <https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax> (last updated Dec. 21, 2022).
- 89 Finance Act 2015, c.11 §102(7).
- 90 *Id.* §§86(1)(h), 87.
- 91 Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes in Income and Capital Gains, U.S.-U.K., art. 5, July 24, 2001, T.I.A.S. 13161 [hereinafter UK Treaty].
- 92 The DPT may or may not be a creditable tax under [Code Sec. 901\(b\)\(1\)](#). See NPRM, 85 Fed. Reg. 72078 (Nov. 12, 2020) (expressing uncertainty whether “novel extraterritorial foreign taxes such as digital services taxes, diverted profits taxes, or equalization levies” are creditable taxes); [T.D. 9959](#) (Jan. 2, 2022) (concluding that digital services taxes are not creditable taxes); [Reg. §1.901-2\(b\)\(5\)\(i\)](#) (applying an “attribution rule” which may or may not operate to disqualify DPT as a credible tax); [Notice 2023-55](#), 2023-32 I.R.B. 427 (temporarily suspending the attribution requirement for most foreign taxes); [Notice 2023-80](#), 2023-52 I.R.B. (extending the temporary suspension of the attribution rule). Even if the DPT were a creditable tax, the U.S. company generally would be prevented from crediting the DPT. The income of the U.S. company from its manufacture of products in the United States and sales into the UK would be U.S.-source income. [Code Sec. 863\(b\)\(3\)](#).

As a result, the U.S. company's tax credit from the DPT would be disallowed under [Code Sec. 904\(a\)](#) (absent other sources of foreign source income). The U.S. company's income is not re-sourced to the UK under the UK Treaty because the United States is not obligated to mitigate double taxation in this scenario, in turn, because under the UK Treaty, the UK is not entitled to tax the income of the U.S. company. UK Treaty, *supra* note 91, art. 24(2).

93 In this instance, the U.S. company's income would be re-sourced to the UK. *Id.*

94 KPMG, TAXATION OF THE DIGITALIZED ECONOMY: DEVELOPMENTS SUMMARY 12 (2023), <https://kpmg.com/kpmg-us/content/dam/kpmg/pdf/2023/digitalized-economy-taxation-developments-summary.pdf>.

95 *Id.* at 32.

96 *Id.*

97 *Id.* at 18, 55.

98 *Id.* at 10.

99 *Id.* at 19.

100 See *id.* at 38 (discussing Italy's DST).

101 Stephanie Soong Johnston, *India's Equalization Levy Not Proposed as Income Tax, Panel Says*, TAX ANALYST (Mar. 22, 2016).

102 European Commission, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market*, COM (2017) 547 final (Sept. 21, 2017).

103 *Id.* at 27.

104 *Id.* at 78.

105 *Id.* at 10.

106 European Commission, *Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence*, COM (2018) 147 final (Mar. 21, 2018).

107 *Id.* at 4.

108 European Commission, *Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services*, at 7–10, COM (2018) 148 final (Mar. 21, 2018).

109 Outcome of the Council Meeting (EC) No. 7368/19 of 12 Mar. 2019 (PR CO 12) 6.

110 See OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy* (Oct. 8, 2021) [hereinafter October 2021 Statement]; Press Release, U.S. Dept. Treasury, Joint Statement from the United States, Austria, France, Italy, Spain, and the United Kingdom, Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 Is in Effect (Oct. 21, 2021).

111 See USTR, REPORT ON FRANCE'S DIGITAL SERVICES TAX PREPARED IN THE INVESTIGATION UNDER SECTION 301 OF THE TRADE ACT OF 1974 (Dec. 2, 2019) [hereinafter USTR France DST Report].

112 Press Release, USTR, USTR Announces, and Immediately Suspends, Tariffs in Section 301 Digital Services Taxes Investigations (June 2, 2021).

113 USTR, Termination of Actions in the Section 301 Digital Services Tax Investigations of Austria, France, Italy, Spain, and the United Kingdom and Further Monitoring, 86 Fed. Reg. 65490 (Nov. 18, 2021).

114 These countries won out in the sense that they were able to keep their DSTs in place, without suffering any retaliatory measures from the United States. Countries with DSTs pending were required to hold off on implementing their DSTs, pending the implementation or non-implementation of Pillar I.

115 Press Release, *supra* note 110.



- 116 See *id.*
- 117 OECD, Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (July 11, 2023).
- 118 See *Members of the OECD/G20 Inclusive Framework on BEPS that Have Approved the July 2023 Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy as of 15 November 2023*, OECD (Nov. 15, 2023), <https://www.oecd.org/tax/beps/outcome-statement-on-the-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2023.pdf>.
- 119 Statement by the Honourable Chrystia Freeland, Deputy Prime Minister of Canada and Minister of Finance, on International Tax Reforms Negotiations (July 12, 2023), <https://deputypr.ca/en/news/statements/2023/07/12/statement-deputy-prime-minister-international-tax-reform-negotiations>.
- 120 See *id.*
- 121 OECD, TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR ONE BLUEPRINT 12 (2020) [hereinafter Pillar I Blueprint].
- 122 A Group is “an Ultimate Parent Entity and any other Entities whose assets, liabilities, income, expenses and cash flows are included in the Consolidated Financial Statements of the Ultimate Parent Entity or would have been so included if the Ultimate Parent Entity had prepared Consolidated Financial Statements.” OECD, THE MULTILATERAL CONVENTION TO IMPLEMENT AMOUNT A OF PILLAR ONE, at art. 2(w) (2023).
- 123 *Id.* art. 3.
- 124 *Id.* arts. 6, 7.
- 125 *Id.* art. 2(b).
- 126 *Id.* art. 2(d).
- 127 *Id.* art. 5.
- 128 *Id.* arts. 9–11.
- 129 *Id.* art. 12.
- 130 OECD, TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY–GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO), at art. 1.1.1 (Dec. 14, 2021) [hereinafter Pillar II Model Rules]. Generally, an MNE Group is “a collection of Entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those Entities: (a) are included in the Consolidated Financial Statements of the Ultimate Parent Entity; or (b) are excluded from the Consolidated Financial Statements of the Ultimate Parent Entity solely on size or materiality grounds, or on the grounds that the Entity is held for sale.”
- 131 *Id.* art. 3.
- 132 *Id.* art. 4.
- 133 *Id.* art. 5.1.1.
- 134 *Id.* art. 5.2.1.
- 135 *Id.* art. 5.2.2. The Substance-based Income Exclusion is essentially a deemed routine profit return with respect to the MNE Group’s payroll and tangible assets.
- 136 *Id.* art. 5.2.3.
- 137 *Id.* art. 3.1.2.
- 138 *Id.* art. 3.2.7.
- 139 *Id.* art. 3.2.3
- 140 See, e.g., *id.* arts. 6.2.1(c), 9.1.3.
- 141 *Id.* art. 3.4.

- 142 *Id.* art. 4.4.
- 143 *Id.* art. 4.4.1.
- 144 *Id.*
- 145 *Id.* art. 4.4.4.
- 146 *Id.* art. 4.1.2.
- 147 OECD, TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – ADMINISTRATIVE GUIDANCE ON THE GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO), at 63 (Feb. 1, 2023) [hereinafter February 2023 Administrative Guidance].
- 148 OECD, TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – ADMINISTRATIVE GUIDANCE ON THE GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO), at 31–32 (July 13, 2023) [hereinafter July 2023 Administrative Guidance].
- 149 Pillar II Model Rules, *supra* note 130, art. 4.3.1.
- 150 The February 2023 Administrative Guidance provided general guidance for allocating taxes with respect to a U.S. shareholder's global intangible low taxed income, included under [Code Sec. 951A](#), see *supra* note 147, but there has been no guidance with respect to the allocation of taxes with respect to a U.S. shareholder's subpart F income, included under [Code Sec. 951](#), or adjusted financial statement income with respect to CFCs for the purpose of the corporate alternative minimum tax under [Code Sec. 55\(a\)](#).
- 151 The OECD's 2020 Pillar II Blueprint referred to an "Income Inclusion Rule" abbreviated to "IIR," and an "undertaxed payment rule" abbreviated to "UTPR." See *infra* note 152. As discussed below, the UTPR later set forth in the Pillar II Model Rules had nothing to do with undertaxed payments. Then, in the table of abbreviations and acronyms in the March 2022 Commentary, "IIR" is an acronym for "Income Inclusion Rule" and "UTPR" is not on the list. See *infra* note 163. Similarly, in the February 2023 Administrative Guidance, the table of abbreviations and acronyms provides that "IIR" is an acronym for "Income Inclusion Rule" and UTPR is not on the list. See *supra* note 147.
- 152 OECD, TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR TWO BLUEPRINT BEPS (2020) [hereinafter Pillar II Blueprint].
- 153 *Id.* at 14.
- 154 *Id.* at 133, 141 n.6, 143 n.32.
- 155 *Id.* at 128–29.
- 156 *Id.*
- 157 *Id.*
- 158 *Id.* at 124.
- 159 October 2021 Statement, *supra* note 110.
- 160 Pillar II Model Rules, *supra* note 130, art. 2.6.1.
- 161 *Id.*
- 162 *Id.* art. 2.4. To the extent that deduction denial was insufficient to achieve an increase to tax equal to the Top-Up Tax allocated to the jurisdiction, the difference would carry forward and apply to deny deductions in a subsequent year. *Id.*
- 163 OECD, TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – COMMENTARY TO THE GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO) (Mar. 14, 2022) [hereinafter March 2022 Commentary].
- 164 Pillar II Model Rules, *supra* note 130, art. 2.4.1.
- 165 March 2022 Commentary, *supra* note 163, at 32.
- 166 July 2023 Administrative Guidance, *supra* note 148, at 77–78.
- 167 *Id.* at 77.

- 168 *Id.*
- 169 *Id.* at 81–83.
- 170 *Id.* at 87–88.
- 171 *Id.* at 88.
- 172 OECD Model Treaty, *supra* note 9, art. 1; U.S. Model Treaty, *supra* note 9, art. 1.
- 173 OECD Model Treaty, *supra* note 9, art. 1; U.S. Model Treaty, *supra* note 9, art. 1.
- 174 OECD Treaty Commentary, *supra* note 14, art. 2, para. 3.
- 175 *Id.*
- 176 Compare UK Treaty, *supra* note 91, art. 2; France Treaty, *supra* note 15, art. 2 with Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Neth., art. 2, Jan. 1, 1994, T.I.A.S. (“Original Netherlands Treaty”), as amended by Protocol to Original Netherlands Treaty Signed on March 8, 2004, U.S.-Neth., Jan. 1, 2005, T.I.A.S. 04-1228.
- 177 *Bricom Holdings Ltd. v. Commissioners of the Inland Revenue* [1997] 70 BTC 471 (appeal taken from Special Commissioners); see also Stuart MacLennan, *The Questionable Legality of the Diverted Profits Tax Under Double Taxation Conventions and EU Law*, 44 INTERTAX 903–12 (2016) (discussing the *Bricom* case with relevance to the DPT).
- 178 Katherine E. Karnosh, *The Application of International Tax Treaties to Digital Services Taxes*, 21 CHI. J. INT’L L. 513 (2021) (arguing that DSTs should be viewed as consumption taxes that are not covered under international tax treaties); Young Ran Kim, *Digital Services Tax: A Cross-Border Variation of the Consumption Tax Debate*, 72 ALA. L. REV. 131 (2020) (same).
- 179 See, e.g., USTR France DST Report, *supra* note 111, at 64; USTR, REPORT ON THE UNITED KINGDOM’S DIGITAL SERVICES TAX PREPARED IN THE INVESTIGATION UNDER SECTION 301 OF THE TRADE ACT OF 1974, at 19 (Jan. 13, 2021) [hereinafter USTR UK DST Report]. But see Kim, *supra* note 178, at 15960 (noting that a turnover tax, which is a tax imposed on sales revenue, is viewed as a consumption tax).
- 180 Karnosh, *supra* note 178, at 519; Kim, *supra* note 178, at 16566.
- 181 Karnosh, *supra* note 178, at 543.
- 182 USTR France DST Report, *supra* note 111, at 55; USTR UK DST Report, *supra* note 179, at 18–19.
- 183 E.g., USTR France DST Report, *supra* note 111, at 55; USTR UK DST Report, *supra* note 179, at 18–19.
- 184 Allison Christians & Stephen E. Shay, *The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties*, 109 TAX NOTES INT’L 445, 447–49 (Jan. 23, 2023).
- 185 *Id.*
- 186 *Id.*
- 187 Angelo Nikolakakis & Jinyan Li, *UTPR: Unprecedented (and Unprincipled?) Tax Policy Response*, 109 TAX NOTES INT’L 745 (Feb. 6, 2023).
- 188 Allison Christians & Tarcísio Diniz Magalhães, *Undertaxed Profits and the Use-It-or-Lose-It Principle*, 108 TAX NOTES INT’L 705 (Nov. 7, 2022).
- 189 *Id.*
- 190 See, e.g., *Giesecke & Devrient [India] Pvt. Ltd. v. Additional Commissioner of Income Tax*, ITA No. 7075/DEL/2017 (India) (decision by the Delhi bench of the Income Tax Appellate Tribunal).
- 191 *Mumbai v. Total Oil India Pvt Ltd.*, ITA No. 6997/MUM/2019 (India) (decision by the Mumbai bench of the Income Tax Appellate Tribunal).
- 192 OECD Model Treaty, *supra* note 9, art. 24(6); U.S. Model Treaty, *supra* note 9, art. 24(7).

- 193 OECD Model Treaty, *supra* note 9, art. 24(1) (nationality), (3) (permanent establishment), (5) (ownership); U.S. Model Treaty, *supra* note 9, art. 24(1) (nationality), (2) (permanent establishment), (5) (ownership).
- 194 Mary C. Bennett, *The David R. Tillinghast Lecture: Nondiscrimination in International Tax Law: A Concept in Search of a Principle*, 59 TAX L. REV. 439, 446 (2006) (“In the case of corporations, Article 24(1) likewise has essentially no impact for U.S. income tax purposes.”).
- 195 *Id.*
- 196 OECD Model Treaty, *supra* note 9, art. 24(1); US Model Treaty, *supra* note 9, art. 24, para. 1.
- 197 OECD Treaty Commentary, *supra* note 14, art. 24, para. 1 lines 7 & 17; Technical Explanation, *supra* note 32, art. 24, para. 1.
- 198 U.S. Model Treaty, *supra* note 9, art. 24(1).
- 199 OECD Treaty Commentary, *supra* note 14, art. 24, para. 1, line 17 (“The different treatment of residents and non-residents is a crucial feature of domestic tax systems and of tax treaties; when Article 24 is read in the context of the other Articles of the Convention, most of which provide for a different treatment of residents and non-residents, it is clear that two companies that are not residents of the same State for purposes of the Convention (under the rules of Article 4) are usually not in the same circumstances for purposes of paragraph 1.”); Bennett, *supra* note 194, at 446.
- 200 OECD Treaty Commentary, *supra* note 14, art. 24, para. 1, line 18.
- 201 OECD Model Treaty, *supra* note 9, art. 24(3); U.S. Model Treaty, *supra* note 9, art. 24(2).
- 202 The permanent establishment paragraph in the OECD Model Treaty provides: “[t]he taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.” OECD Model Treaty, *supra* note 9, art. 24(3). Applying the model treaty’s definitions of “enterprise of a Contracting State” and “enterprise of the other Contracting State,” the permanent establishment paragraph is to be read as follows: “The taxation on a permanent establishment which [ a business of a resident] of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on [ a business of a resident] of that other State carrying on the same activities.” *Id.* art. 3(1c)-(1d).
- 203 OECD Model Treaty, *supra* note 9, art. 24(5); U.S. Model Treaty, *supra* note 9, art. 24(5).
- 204 Bennett, *supra* note 194 at 454; *see also, e.g., UnionBancCal Corp. v. Commissioner*, 305 F.3d 976, 981 (9th Cir. 2002) (“But it hasn’t shown that it would have been treated any differently had Standard been American.”); *Square D Co. v. Commissioner*, 438 F.3d 739 (7th Cir. 2006) (analyzing the ownership paragraph by comparing a French-owned U.S. corporation to “a corporation were owned by a United States parent”).
- 205 Technical Explanation, *supra* note 32, art. 24.
- 206 *Id.*
- 207 *Id.* para. 2.
- 208 [Code Sec. 1446\(a\)](#).
- 209 *Id.*
- 210 [Code Sec. 871\(b\)](#); [Code Sec. 882\(a\)\(1\)](#).
- 211 Technical Explanation, *supra* note 32, art. 24, para. 5.
- 212 *See supra* Part II.A.
- 213 *See* Tariff Act of 1909, H.R. 1438, 61st Cong. §37 (1909).
- 214 232 U.S. 261 (1914).
- 215 *See id.* at 283.
- 216 *See id.* at 282–83.

- 217 232 U.S. 299 (1914).
- 218 *See id.* at 305.
- 219 *See id.* at 307.
- 220 *Id.* at 305.
- 221 *Id.* at 307.
- 222 *Id.*
- 223 265 U.S. 47 (1924).
- 224 *See id.* at 54.
- 225 *See id.*
- 226 *Id.* at 56.
- 227 *See id.*
- 228 *See id.*
- 229 79 F.2d 245 (2d Cir. 1935).
- 230 *See id.* at 246.
- 231 390 F.2d 631 (1st Cir. 1968).
- 232 *See id.* at 631–32.
- 233 *See id.* at 632.
- 234 *See id.*
- 235 *See supra* Part II.E.
- 236 *See* [Code Sec. 864](#); *see also* [Reg. §1.6038-4](#) (2016).
- 237 *See* Christians & Shay, *supra* note 184, at 448.
- 238 *See generally* U.N. Model Double Taxation Convention Between Developed and Developing Countries (2021), <http://financing.desa.un.org/document/un-model-double-taxation-convention-between-developed-and-developing-countries-2021> [hereinafter UN Model Treaty].
- 239 *See supra* Part III.C.
- 240 *See id.*
- 241 *See* UN Model Treaty, *supra* note 238.
- 242 *See id.* art. 12A.
- 243 *See id.* art. 12B.
- 244 *See id.*
- 245 *See id.*
- 246 *See id.*
- 247 *See id.*
- 248 *See id.*
- 249 *See id.*
- 250 *See id.*
- 251 *See* Paul Oosterhuis, Skadden, Arps, Slate, Meagher & Flom, 25th David R. Tillinghast Lecture on International Taxation: Revisiting an Age-Old Question: What Taxes Should Be Treated as Income Taxes (Oct. 12, 2023). This “Source-Residence Renegotiation Approach” is derived from this author’s understanding of the approach outlined by Paul Oosterhuis in his lecture.



- 252 See [Code Sec. 861\(a\)\(3\)](#); [Code Sec. 862\(a\)\(3\)](#).
- 253 See UN Model Treaty, *supra* note 238, art 12B.
- 254 See *supra* Part III.A.
- 255 See *supra* Part IV.A.
- 256 See *supra* Part III.C.
- 257 See March 2022 Commentary, *supra* note 163, at 39.
- 258 See *id.*
- 259 See *id.* at 41.
- 260 See *id.*
- 261 See OECD Pillar Two Country Tracker, PwC, <http://www.pwc.com/gx/en/services/tax/pillar-two-readiness/country-tracker.html> (last updated Dec. 11, 2023).
- 262 See *id.*