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A Theoretical Support of the OECD's Two Pillar Solution, and its Approach to Jurisdiction to Tax

경제협력개발기구(OECD) "Two Pillar Solution"의 조세 관할권 접근에 대한 이론적 분석

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Graduate School of Law
Seoul National University
International Law Major

Lucrezia Lawrance

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Lee Keun-Gwan

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Lucrezia Lawrance

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Lucrezia Lawrance
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Chair	Jaemin Lee
Vice Chair	Yoo Min Won
Examiner	Lee Keun-Gwan

Abstract

The current international corporate income tax system maintains the same form it did upon its establishment in the early 1960s; it bases taxation upon the factors of residence and source, requiring physical presence to ground jurisdiction to tax. The international business environment, on the other hand, has changed dramatically. The rapidly accelerating pace of digitalisation of the economy has led to a taxation system that no longer functions effectively, and consequently to an erosion of states' jurisdiction to tax. Corporations are able to take advantage of their ability to operate simultaneously in multiple jurisdictions, often without a physical presence. In doing so, they reduce their tax burden artificially by shifting profit between jurisdictions and situating their headquarters in tax haven countries. In response, at the behest of overwhelming political consensus, the Organisation for Economic Cooperation and Development proposed its Two-Pillar Solution in October 2020. Made up of two 'Pillars', the proposed measures introduce a taxing right over sales made in a jurisdiction even without physical presence (Pillar One's Amount A), and impose a global minimum corporate income tax rate of fifteen percent (Pillar Two). This paper argues that current international tax law requires a close connection between the subject of corporate income tax and the state imposing such tax; this nexus requirement forms the basis of the jurisdictional principle in the context of tax law. The proposed Pillar One and Pillar Two measures are analysed in light of this principle of jurisdiction. Pillar One's Amount A, although it amounts to an expansion of jurisdiction, does not go so far as to violate the nexus requirement; it finds the connection not in physical presence but instead in the imposition of a revenue threshold. Thus this paper is in support of Pillar One. With regards to Pillar Two, the Income Inclusion Rule allows a state to require the parent corporation of a foreign subsidiary to include the income of that subsidiary in its own tax returns. It thus functions on a similar jurisdictional basis to the already existing Controlled Foreign Corporation taxation rules. As a result, it does not amount to a violation of jurisdictional principles. The Under-taxed Payments Rule, on the other hand, remains an issue; it appears to allow taxation where there is no link, direct or indirect, between the income taxed and the state imposing the tax. It does so by allowing a third party state to deny tax deductions on cross-border payments between subsidiaries from the same parent group, simply on the basis that the subsidiary making the transfer is subject to an effective tax rate less than fifteen percent. This conflicts with the nexus requirement. It is concluded that Pillar Two is best implemented by use of a treaty explicitly creating an exception to, or expansion of, current jurisdictional principles of international taxation law.

Keyword : corporate income tax, jurisdiction, OECD, Pillar One, Pillar Two
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1.1. Introduction

In late 2019, the United States adopted trade sanctions against France, in the form of a twenty-five percent tariff on French sparkling wines, luxury goods and cosmetics.[1] Such action was in retaliation to France's unilateral adoption of a Digital Services Tax (DST); according to the US, the French DST was "particularly burdensome for US companies" and thus ruled to be discriminatory.[2] Yet France was not the only jurisdiction to provoke the US' ire. In fact, six countries had already put in place similar taxes, and in June 2021 the US imposed tariffs on particular goods coming from each of these jurisdictions, on the basis that the DSTs discriminated against US companies.[3] This wave of unilateral measures, and resulting trade tensions, did not come out of nowhere. It was sparked by tensions that have been festering over the past decades, and is yet another symptom of a fact that has become impossible to ignore: the current international taxation framework is outdated, and it is costing states billions in tax revenue.

The way in which businesses are structured has changed dramatically since international tax rules were first written. Many large corporations have grown to become "multi-national corporations" (MNCs). The OECD's literature on MNCs does not provide a precise definition, but indicates that MNCs operate in all sectors of the economy, and normally "comprise companies or other entities established in more than one country and so linked that they may co-ordinate their operations in various ways".[4] It should be noted that some authors use

[1]Doug Palmer, 'US Announces Duties on €1.3B in French Goods in Digital Tax Dispute' (Politico, 11 July 2020) <https://www.politico.eu/article/ustr-announces-duties-on-1-3b-in-french-goods-in-tax-dispute/> accessed on 23 April 2023.
[2]Reuven Avi-Yonah, 'A New Framework for Digital Taxation' (2022) 63 Harv Int'l LJ 279, 319.
[3]*Ibid*, 320: those six jurisdictions were Austria, India, Italy, Spain, Turkey, and the United Kingdom; it should also be noted that these trade tariffs have been kept on hold whilst OECD negotiations are ongoing, in hopes that Pillar One's implementation will resolve the issue, since it will require removal of unilateral DSTs.
[4]OECD, *OECD Guidelines for Multinational Enterprises on Responsible Business Conduct* (8 June 2023), 1.4. For detailed information on MNCs and their corporate structures, see the OECD-UNSD Multinational Enterprise

the term “transnational corporation”, but it can be viewed as simply another name for the same concept.[5] MNCs have become dominant forces on the international stage, often enjoying a monopoly over certain markets; in fact, in 2016, MNCs contributed thirty-two percent of world GDP.[6] Particularly pertinent examples are Google, Apple, Facebook, and Amazon, which are often labelled the “GAFA four”. It should be noted that the “GAFA” label, when used in literature, is usually not intended to refer exclusively to these four named firms, but rather as more of an umbrella term for this type of large-scale digital MNCs, which personify the problem that the international tax system finds itself faced with.

This problem is one of extremely effective, and distortive, tax avoidance by “GAFA” MNCs. Globalisation and inter-connection of markets has led to a huge shift in the way in which businesses operate – a shift which the international taxation framework has not been able to keep up with. MNCs have taken advantage of this situation to structure their tax affairs in such a way that they shoulder little to no tax burden. This is done by use of base erosion and profits shifting measures, referred to as BEPS by the Organisation for Economic Cooperation and Development. Such measures use gaps and mismatches in the taxation system to avoid taxation; for example, the shifting of profit between subsidiaries located in different jurisdictions worldwide, so that those profits are taxed in low- or no-tax jurisdictions. A recent case that drew much international attention is that of Apple, which won an appeal at the EU’s General Court in July 2020. The action was originally brought against Apple by the European Commission, which claimed that Apple had avoided paying tax on EU revenue by attributing nearly all such revenues back to an Irish head

Information Platform, at <https://www.oecd.org/sdd/its/mne-platform.htm>accessed 25 July 2023.

[5]The United Nations Conference on Trade and Development regularly publishes literature relating to MNCs, and in this literature the term ‘transnational corporations’ is used. Similarly to the OECD, the UN has also attempted to negotiate a Code of Conduct for MNCs. However, although negotiations began in 1972, attempts to reach a Code eventually failed. See Draft United Nations Code of Conduct on Transnational Corporations [1983 version], and for a detailed history, see Karl Sauvant, ‘The Negotiations of the United Nations Code of Conduct on Transnational Corporations: Experience and Lessons Learned’ (2015) 16 *Journal of World Investment and Trade* 11.

[6]Koen de Backer, Sebastien Miroudot and Davide Rigo, ‘Multinational Enterprises in the Global Economy: Heavily Discussed, Hardly Measured’ (VOXEU, 25 September 2019) <https://cepr.org/voxeu/columns/multinational-enterprises-global-economy-heavily-discussed-hardly-measured> accessed on 24 April 2023.

office.[7] This Irish head office effectively only exists on paper, so that Apple can make use of Ireland's extremely low corporate tax rates; such an arrangement is a typical example of BEPS measures being put to use. The key takeaway here is that Apple, in structuring its tax affairs in this way, has done nothing in violation of current taxation laws, thus highlighting the need for change if BEPS measures are truly to be effectively addressed.

Alongside the rapid rise of MNCs, the geography of trade and business on the international scale had already begun changing drastically thanks to exponential growth and advances in digital technology. This already rapid digitalisation of the global economy, largely left unaddressed by the existing international taxation framework, was sped up even further by the conditions of the COVID-19 pandemic. In fact, over the past fifteen years, growth of the digital economy has occurred at a rate two and a half times faster than that of global GDP.[8] Thus, some of the most market-dominating MNCs are digital goods and services companies, with little to no physical presence in the jurisdictions where they make their profits. Since the current taxation framework is built around physical presence in a jurisdiction, it does not function to allocate taxing rights over digital firms in such cases. These digital coporations benefit from users and distribution networks within a jurisdiction, but the state has no corresponding rights of taxation. Not only this, but the digital economy has brought to the forefront the problem of BEPS measures, since digital goods and services firms are uniquely able to make use of these measures due to their inherent flexibility.

The situation has made the current taxation system's shortfalls very clear, and states, spurred by the 2008 financial crisis and fiscal difficulties of the COVID-19 pandemic, have decided that changes must be made. This has sparked a series of proposals by the OECD, namely their Two Pillar Solution, which is the focus of this thesis. However, since discussion and negotiation over the OECD proposals has taken much longer than first intended, many states have taken matters into their own hands and enacted DSTs in the meantime. This

[7] BBC News, 'Apple Has €13bn Irish Tax Bill Overturned' (BBC News, 15 July 2020) <https://www.bbc.com/news/business-53416206> accessed on 23 April 2023; Case T-892/16 *Apple Sales International and Apple Operations Europe v Commission* (2020) EU:T:2020:338.
[8] Bloomberg Tax, 'Understanding Digital Services Taxes & The OECD' (Bloomberg Tax, 4th January 2023) <https://pro.bloombergtax.com/brief/understanding-digital-services-taxes-the-oecd/> accessed on 24 April 2023.

has not been viewed positively by the United States, which, as discussed above, views such measures as discriminatory towards its resident corporations. The US has therefore adopted a rather protective stance towards the GAFA companies, complicating negotiations for Pillar One in particular.

1.2. Historical Development of the International Taxation Framework

To understand the structure of international tax law as it currently stands, it is necessary to have some understanding of how international tax law developed historically.

Taxation has since the beginning of the nation state been viewed as a core component of state sovereignty, and a vital tool for raising revenue for the state. This revenue being used for such essential purposes as state building, internal management and negotiated expansion, taxation is clearly a matter of great importance to states.[9] As a manifestation of state sovereignty, the creation of a taxation system has traditionally been considered entirely within a state's discretion. Thus domestic tax systems were designed with little thought as to how they would interact with influences from outside a state's borders, or even with other taxation systems of neighbouring states. Such a structure functioned relatively well in earlier ages, when contact with other states was limited, and thus could be dealt with as an exception to the established rules.

However, with the increase in interaction between states due to globalisation, particularly in the form of movement of goods and services, there was a need for development of rules on the international level to govern the interaction between domestic taxation systems. Without such organisational rules, many companies were subject to double taxation: the imposition of taxes upon the same income or subject matter by the tax authorities of two or more states. Double taxation, though an entirely legal and often unintended consequence of tax legislation, is considered a problem by the international community as it can lead to a total tax rate high enough to discourage international business, thus constituting a barrier to international trade. Since taxation is regarded as such a fundamental part of state sovereignty, governments were reluctant to adopt multilateral solutions, which could be viewed as moving taxation decisions outside of the realm of state

[9] Allison Christians, 'Introduction to Tax Policy Theory' (2018) available online at SSRN: <https://dx.doi.org/10.2139/ssrn.3186791>, 2.

discretion and onto a supranational level.[10] Instead, states turned towards bilateral agreements, which could be more easily negotiated so as to reach an acceptable compromise from both parties' points of view, and were possible even with widely differing interpretative positions globally.[11] This development of a large number of bilateral agreements has, however, led to a structure with continued issues; the main examples being unplanned gaps that are easily exploited by tax payers, and a system that facilitates increased tax competition in what is effectively a "race to the bottom".

1.3. The Current Corporate Income Taxation System

This thesis, since it aims to assess the Two Pillar Solution, will focus solely on corporate income tax. The current existing framework of corporate income tax is largely modeled on the OECD Model Tax Convention. In fact, more than three thousand tax treaties currently in force are based upon the OECD Model.[12]

The Organisation for Economic Co-operation and Development (OECD) originally began as the Organisation for European Economic Co-operation (OEEC), created after the Second World War in order to oversee the administration of aid under the United States and Canada's Marshall Plan. After Canada and the United States joined in 1961, the organisation was renamed the OECD. The OECD aims to promote economic development and cooperation, and as such it lists removal of trade barriers and tax transparency as important objectives. In pursuit of these aims, it has developed, alongside economic reports and investigations, around 460 substantive legal instruments, including three legally binding international agreements in the field of tax law.[13]

[10]Taxation carries such weight as a political issue that it would have been almost impossible for countries to agree on a single approach to taxation: Keigo Fuchi, 'Unilateralism, Bilateralism, and Multilateralism in International Taxation' (2016) 59 *Japanese Yearbook of International Law* 216, 223. Turning to the current situation, the problems raised by digitalisation of the economy have created enough pressure that states are willing to turn to multilateral action.

[11]*Ibid*, 221; Kim Brooks, 'The Potential of Multilateral Tax Treaties' in Michael Lang et al., (eds.) *Tax Treaties: Building Bridges between Law and Economics* (IBFD, 2010), 226-7.

[12]OECD, 'Tax Treaties: Update to OECD Model Tax Convention Released' (OECD, 18 December 2017) <https://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm> accessed on 23 April 2023

[13]OECD Legal Instruments, <https://www.oecd.org/legal/legal-instruments.htm> accessed on 24 April 2023; The Convention on Mutual

The OECD's first Draft Model Tax Convention was published in 1963, following the drafting of two opposing tax treaty models: the 1943 Mexico Draft Model, and the 1946 London Draft Model.[14] These models reflected the significant tensions between developing countries' preference for source-based taxation, and developed countries' argument for residence-based taxation. In the end, it was the pro-residence London Draft that had the greater impact upon the then twenty-member OECD, resulting in an OECD Model Convention that allocates taxing rights on both residence and source basis. The Convention has been periodically updated as case law has developed and the OECD BEPS Project has come together, with the most recent version being published in 2017.[15]

The Model Convention divides taxing rights on business profits between the resident state and the source state. Thus, a state's jurisdiction to tax is derived from the fact of a taxpayer being resident within that state. Where a corporation is not resident, a state may still exercise taxing rights if the corporation is deemed to have a permanent establishment (PE) within that jurisdiction. Tax paid in that source state will then be credited by the country of residence, or the relevant profits exempted from tax levied by the state of residence, so as to avoid double taxation.

The concept of PE is used to determine whether taxation of a corporation's business profits by a state other than the state of residence is appropriate. It is therefore a legal construct created solely for the purpose of tax law, and does not correspond to any term in company law. This has led to extensive case law regarding exactly what constitutes a permanent establishment.[16] The Model Tax

Administrative Assistance in Tax Matters (1988), the Protocol Amending the Convention on Mutual Administrative Assistance in Tax Matters (2010), and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (2016).

[14] Allison Christians and Tarcísio Magalhães, 'Why Data Giants Don't Pay Enough Tax' (2023) *Harvard Law & Policy Review*, Forthcoming, available at SSRN: <https://dx.doi.org/10.2139/ssrn.4342650>, 43-4.

[15] OECD Model Tax Convention (2017) ["Model Convention"]; the Model Tax Convention has, since its first release, been updated in 1992, 1998, 2000, 2003, 2005, 2008, 2010, 2014, and 2017. However, the underlying principles and organisation have remained the same since they were originally introduced.

[16] Examples of key cases on the definition of PE include: *The Taisei Fire and Marine Insurance Co., Ltd., et al., (Petitioners) v Commissioner of Internal Revenue (Respondent)* (1995) 104 TC 535 (United States Tax Court) [interpretation of 'an independent agent' – held: since the agent was legally

Convention states that "the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on".[17] This definition creates three requirements for recognition of a PE: a physical place of business, with a certain degree of permanence, through which business is carried on. What is clear from the literature surrounding the concept of PE is that traditionally a physical presence of some kind is required in order for a state to have taxing rights over a non-resident company.[18]

Another key concept established by international taxation law is the arm's length principle (ALP). This principle is the international consensus on transfer pricing; it is used for the valuation of cross-border transfers of assets between associated corporations. In an open market, transactions between independent enterprises are influenced by external market forces, such that the price reached can be said to be the fair market value. When the transaction is between associated enterprises, these external market forces do not directly affect the transfer in the same way, and this leaves the resulting costs and profits open to manipulation. Transfer pricing adjustment according to the arm's length principle is intended to counteract this, with such adjusted transfer pricing reflecting market forces and avoiding tax distortion. The authoritative statement is made by Article 9 of the OECD Model Tax Convention, which provides that "[where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in

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and economically independent of the companies, it did not amount to a PE and was instead an agent of independent status under the treaty]; *McDermott Industries (Aus) Pty Ltd v FC of T* [2005] FCAFC 67 (Australia) [whether a non-resident lessor without any physical presence in the jurisdiction can have a PE, if it leases physical equipment in said jurisdiction – held: bareboat charter of a vessel by a Singaporean resident to an Australian entity did give rise to an Australian PE for the Singaporean entity]; *Knights of Columbus v The Queen* [2008] TCC 307 (Canada) [whether home offices could constitute PE of the employer – held: the home offices were not at the disposal of the employer, so did not constitute a PE]. For commentary on the historical development of the PE concept before the BEPS project, see Xaver Ditz and Carsten Quilitzsch, 'The Definition of Permanent Establishment: Current OECD and German Case Law Developments' (2012) 40:10 *Intertax* 556.

[17] Model Convention (no 15), article 5(1).

[18] E.g. Peter Harris, *International Commercial Tax* (CUP 2nd ed, 2020) 170, 172-3, 273-4.

the profits of that enterprise and taxed accordingly".[19]

1.4. BEPS Action Plan

In 2016, the OECD formed the OECD/G20 Inclusive Framework on BEPS (IF) to work on combating BEPS measures. This group numbers over 135 countries and jurisdictions, and participates in development and review of fifteen Actions presented in 2015, aimed at improving the coherence and transparency of the international taxation system.[20] Among these actions number Action One, aimed at addressing the problems of the digital economy, and Action Fifteen, to put together a multilateral instrument. Pillars One and Two are the dual elements of the Two-Pillar Solution, the blueprints for which were put forward under Action One in October 2020. These two proposals are, according to the OECD and G20, intended to address the issues detailed above, and thus restore states' tax sovereignty in the context of the digital economy.

1.4.1. Pillar One

Pillar One is intended to deal with the problems raised by the digital economy. The concepts brought to bear by Pillar One originally grew from the idea of a "GAFA tax", a tax intended to cover those particular digital MNCs which have rapidly come to dominate the market worldwide (Google, Amazon, Facebook and Apple). However, during negotiations, the scope of Pillar One was expanded from the GAFA four to digital goods and services companies in general, due to push-back from the United States. Even though the scope has now widened to include companies beyond GAFA firms, the majority of MNCs predicted to fall in scope remain US-headquartered MNCs; US-headquartered companies are estimated to generate 64 percent of the total estimated Pillar One revenue.[21] This is simply due to the fact that the majority of large MNCs tend to be US residents, and thus Pillar One will impact the US to a greater degree than other nations.[22] Pillar One

[19]Model Convention (no 15), article 9.
[20]OECD, *OECD/G20 Inclusive Framework on BEPS: Progress Report September 2021 – September 2022* (OECD, 4 October 2022) 2.
[21]Martin Simmler and Michael Devereux, 'Who Will Pay Amount A?' (2021) 5 EconPol Policy Brief 36, 36.
[22]Robert Goulder, 'The Price of Tax Reform: Pillar 1 Reduced to the Back of a Napkin' (Forbes, 6 July 2021) <https://www.forbes.com/sites/taxnotes/2021/07/06/the-price-of-tax-reform-pillar-1-reduced-to-the-back-of-a-napkin/?sh=3df7749b6868> accessed on 24 April 2023.

consists of three elements: Amount A, Amount B, and a dispute settlement mechanism.

Amount A

Amount A creates a new taxing right for market jurisdictions over a share of MNC groups' residual profits. This taxing right aims to tax in the jurisdiction of the end user by reallocating a share of residual profit where an MNC group earns above a certain amount within a jurisdiction, regardless of whether that MNC has a physical presence within that particular jurisdiction. The threshold for falling within Amount A is a global turnover above 20 billion euros, coupled with a residual profitability level above 10 percent. Amount A will be covered in much greater detail in Chapter III.

Amount B

Amount B is often referred to as a tax on baseline marketing and distribution activities in surrounding literature. This is because the portion of profits subject to tax under Amount B is calculated based upon a formula, which takes into account factors related to a corporation's marketing and distribution activities. In essence, Amount B is intended as a supplement to the existing arm's length principle, simplifying the application of such principle. It will apply to intra-group transactions, where goods are purchased for the purpose of wholesale distribution to unrelated corporations. The most recent related update was a consultation document on the major design elements of Amount B, launched in December 2022, with corresponding public comments published by the OECD at the end of January 2023.

Amount B applies to those MNCs which carry out distribution activities within a market jurisdiction. It will apply to "buy-sell" arrangements, and may possibly also apply to sale and commissionaire arrangements.[23] Currently, only tangible goods are within scope, though there is some discussion as to whether services and software, or other digital goods, should also be included.[24] Determination of scope is mainly driven by the level and type of functions performed, risks assumed, and assets owned by the parties to the transaction; the scoping criteria envisioned contain a mix of qualitative assessments

[23] OECD, *Public Consultation Document: Pillar One – Amount B* (December 2022) ["Amount B"], 17 Box 3.1.
[24] *Ibid*, 25 [28-29].

and quantitative measurements, and are still under evaluation.[25] The proposals also include a list of activities which will exclude a corporation from falling within scope. These are manufacturing, research and development, procurement, and financing activities.[26] However, as of the most recent consultation document in July 2023, this area of Amount B is still unsettled, since there are concerns about whether such activities, performed under a certain threshold, may simply be considered ancillary activities and thus would not have a material effect on arm's length prices.[27] Conflict has erupted between states, with two rival approaches surfacing; these are referred to in the OECD document as Alternative A and Alternative B.[28] Alternative A argues for a more objective, quantitative screening approach based upon operating expense intensity to be used in determining eligibility. On the other hand, Alternative B calls for an independent, subjective test eliminating distributors performing "non-baseline contributions". Thus, although the July 2023 document represents progress on Amount B, this dispute has become yet another obstacle to finalising the project.[29]

<u>Dispute settlement mechanism</u>

The final element that Pillar One introduces is a mandatory binding dispute resolution, for disputes related to transfer pricing and permanent establishment issues. Special exclusions have been suggested for developing countries with little experience in Mutual Agreement Procedure (MAP) disputes. It should be noted that there may also be an elective binding dispute resolution mechanism for issues relating to Amount A, for developing countries with little experience in MAP disputes.

The Blueprint for Pillar One, published in October 2020, was only a rough outline without many specific details relating to thresholds and numbers.[30] The most recent update released in July 2022 fills in many of these gaps, providing specific provisions, calculation formulae and

[25]For more detail, see Amount B (no 23), 9-12.
[26]*Ibid*, 10.
[27]OECD, *Public Consultation Document: Pillar One – Amount B* (July 2023) ["Amount B – July 2023"]
[28]*Ibid*, Box 2.1.
[29]For more detail on Alternative A and Alternative B, see Ryan Finley, 'OECD Agreement on Amount B Tax Deal Remains Elusive' (TaxNotes, 27 July 2023) <https://www.taxnotes.com/opinions/oecd-agreement-amount-b-tax-deal-remains-elusive/2023/07/27/7h0py> accessed 30 July 2023.
[30]OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* (October 2020) ["Pillar One Blueprint"].

thresholds; although it should be noted that this formulation of Pillar One is not final, and there continue to be open issues and public consultations.[31]

1.4.2. Pillar Two

Pillar Two "seeks to develop rules that would provide jurisdictions with a right to 'tax back' where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation".[32] In other words, it aims to neutralise tax competition and the issue of base erosion by introducing a global minimum corporate tax, at a rate of fifteen percent, and allowing residence states to recover tax where the source state does not impose this minimum effective rate of taxation. Pillar Two is also referred to as the "Global Anti-Base Erosion" rules (GloBE). It consists of four main elements: the income inclusion rule, the undertaxed payments rule, a switch-over rule, and a subject to tax rule.

Together, Pillar One and Pillar Two form the OECD's answer to the issues arising from the digitalised economy, and aggressive tax planning. They are accompanied by a multilateral convention, intended to aid implementation of these measures, and any future changes.

1.4.3. The Multilateral Convention

Implementation of Pillar One and Pillar Two will differ in method, according to the different characteristics of each. Pillar Two is intended to be implemented by states through domestic legislation, and therefore will not entail a related treaty. On the other hand, Pillar One is much more complex, and will require updating of all bilateral tax treaties that are currently in existence. As a result, it has been agreed by the states involved that a multi-lateral instrument is necessary in order to implement Pillar One. An ad hoc group was formed in February 2015 for the purpose of developing this instrument, in which ninety-nine countries participated as members.[33]

[31] OECD *OECD/G20 Base Erosion and Profit Shifting Project: Progress Report on Amount A of Pillar One – Public Consultation Document* (July 2022) ["Amount A Progress Report"], 9 [5].
[32] OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (2019) [7].
[33] OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (2017) ["Explanatory Statement"], [7].

On June 7th 2017, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" was signed by seventy-six jurisdictions.[34] As of April 2023, one hundred jurisdictions have joined the convention.[35]

1.4.4. Current Status

Progress has somewhat stalled on Pillar One, with focus seeming to have moved to implementing Pillar Two's global minimum tax first. This is due in large part to the complexity of Pillar One, and concerns that it will not bring in enough revenue to make it a viable alternative to the DSTs which it will replace. The last few updates from the OECD have thus concerned Pillar Two, the most recent released in February 2023. The Two-Pillar Solution clearly remains a work in progress, and seems to be facing significant barriers. Considering the changes that the proposals are intending to make are revolutionary, it is unsurprising that work to implement them has taken so much time. Taxation constitutes the core of states' sovereignty and thus is an area that governments actively monitor; reaching agreement between so many different jurisdictions is an ambitious task in the best of times.

Developing countries have voiced their concerns with regards to Pillar One, with criticisms mainly revolving around the low expected revenue returns, high implementation costs and complexity, and a scoping rule that excludes a large majority corporations headquartered in developing countries. For example, representatives for Nigeria's Federal Inland Revenue Service have voiced concerns that Pillars One and Two will bring in "little or no money … to developing countries", with Pillar One's proposed Amount A tax covering only six companies in the entirety of Nigeria.[36] In fact, because of the rather restrictive scope of Amount A, developing countries have, through the Intergovernmental Group of 24, expressed concerns that they may gain more from imposing a unilateral digital services tax (DST) than from joining Pillar One, which,

[34] International Chamber of Commerce, 'ICC Welcomes OECD's Landmark Global Tax Agreement' (8 June 2017) <https://iccwbo.org/news-publications/news/icc-welcomes-oecds-landmark-global-tax-agreement/> accessed on 24 April 2023.
[35] OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS – Information Brochure* (OECD, January 2023) ["Info Brochure"], 3.
[36] Carlos Mureithi, 'Why Kenya and Nigeria Haven't Agreed to a Historic Global Corporate Tax Deal' (Quartz, 2 November 2021) <https://qz.com/africa/2082754/why-kenya-and-nigeria-havent-agreed-to-global-corporate-tax-deal> accessed on 24 April 2023.

as part of the package, requires members to repeal all unilateral DSTs.[37]

Another area that has been stalling progress with Pillar One is the arbitration mechanism for dispute resolution included in the plans. Members of many countries are concerned that such mandatory and binding mechanism erodes the sovereignty of the taxing jurisdiction, by moving the resolution of tax issues into the home countries of the affected corporations instead. Sengupta, for example, takes a particularly negative view of Pillar One, terming it as the OECD's attempt to "bring back its proposal of binding arbitration through the back door".[38]

Nor is Pillar Two free of censure; it has been criticised as undermining states' fiscal sovereignty, since by imposing a minimum tax rate, Pillar Two removes the possibility of offering tax incentives in order to attract foreign investment.[39] Pillar Two itself is a discretionary scheme, and states that choose not to participate are not required to meet the minimum fifteen percent tax rate. However, in practice, any state that does attempt to use tax incentives in this way is unlikely to receive the expected foreign direct investment benefits; this is because Pillar Two operates by allowing third party states to impose "top up" tax that effectively cancels out the tax incentive offered by the first state. This issue looks at the question of jurisdiction from the opposite perspective, namely a state's jurisdiction not to tax. Other commentators have argued that the decision to increase or decrease corporate tax is a political one, perhaps best left to democratically elected political leaders.[40]

1.5. Thesis Overview

Much discussion has been made of the potential impacts of the Two Pillar Solution on government tax revenues, inter-nation equity, tax compliance costs and more, but the issue of jurisdiction constitutes a fundamental pillar not only of international tax law, but international law

[37]Alex Voorhoeve and Tove Ryding, 'Is the Organisation for Economic Cooperation and Development's 2021 Tax Deal Fair?' (2022) 2:4 *LSE Public Policy Review* 1, 4.
[38]D Sengupta, 'OECD's Unified Approach to Pillar One – Know Your [A], [B], [C]' (2019) *Tax India International* 1, 3.
[39]Bruno da Silva, 'Taxing Digital Economy: A Critical View Around the GloBe' (2020) 15(2) Frontiers of Law in China 112, 123.
[40]Mindy Herzfeld, 'Are Pillars 1 and 2 Compatible with Sovereignty and Democracy?" (2020) 169:10 *Tax Notes* 1557.

in general. As noted at the beginning of this chapter, international tax law is at its essence concerned with allocating states' competing powers to tax, and the tool it employs to do so is that of jurisdiction.
This thesis aims to provide theoretical support to the OECD Pillar One and Pillar Two proposals from the perspective of public international law; specifically, it will argue that the changes these proposals make to the principles of jurisdiction in international tax law do not violate more general principles of jurisdiction, and remain in line with the theories that underpin jurisdiction to tax as a whole. Thus, the fears that Pillars One and Two completely "disregard" international law are overblown.[41] However, it is conceded here that Pillar Two's UTPR is in conflict with current norms of jurisdiction, and should states wish to push it through, they should do so by explicitly recognising it as overruling, or forming an exception to, the current status quo. Such a position would require an instrument of international law, namely a multilateral treaty.

It is necessary, first, to begin with a discussion of the concept of jurisdiction, specifically looking at the question of whether international law imposes limits on a state's jurisdiction to tax, and if so, what these limits are (Chapter II). This thesis will argue that there is indeed a limit, which imposes the requirement of a sufficient nexus between the state and the object of taxation. Having made this assertion, focus will turn to Pillar One's Amount A taxing right (Chapter III). The question of whether theoretical support exists for the exercise of source-based jurisdiction where there is no physical presence will be addressed. Next, this thesis will look at Pillar Two, and whether the imposition of "top up" tax by residence states can be said to be firmly supported by jurisdiction under international tax law (Chapter IV).

[41] Yariv Brauner has indicated his concerns with the OECD measures, describing them as evidence of a "casual disregard for international law, including international tax law", "even among some of the world's most prestigious tax experts". See Yariv Brauner, 'Editorial Note: The Rule of Law and Rule of Reason in the Aftermath of BEPS' (2023) 1:4 Intertax 268.

Chapter 2. Jurisdiction in the Context of International Tax Law

2.1. Introduction

"The power of taxation, however vast in its character and searching in its extent, is necessarily limited to subjects within the jurisdiction of the state".[42] Such statement appears to simply state the painfully obvious, yet it raises a very important question: in matters of fiscal sovereignty, how far does the afore-mentioned jurisdiction of the state reach? Are there any limits imposed upon states, other than those they themselves take on through the agreement of treaties?

This Chapter will attempt to address the question of jurisdiction in the context of international tax law. Perhaps surprisingly for a field of law that has generated as much legal attention and academic comment as international taxation, the interaction between public international law (PIL) and international tax law is not often a focus of analysis. One could even say that it seems that international taxation law is often regarded from the domestic viewpoint, country by country, rather than as a body of law that is part of the greater ecosystem of international law. As Christians points out, tax law has, and continues to be, regarded as "governed mainly, if not exclusively, by national legal regimes and bilateral conventions voluntarily entered into by states"; consequently, many scholars, and practitioners, discussing taxation law concerns do not tend to draw from PIL principles on a more general international level.[43] Such viewpoint comes through strongly in

[42] *State Tax on Foreign-Held Bonds*, (1872) 15 Wall 300 (US) Field J.
[43] Christians (no 14), 17-8; it should be noted that this is not to say that no such discussion exists at all. Examples of tax practitioners approaching tax law from a public international law viewpoint do exist; these include discussion of how the Vienna Convention on the Law of Treaties views the OECD Commentaries, for example. See Maria Hilling and Ulf Linderfalk, 'The Use of OECD Commentaries as Interpretative Aids: The Static/Ambulatory Approaches Debate Considered from the Perspective of International Law' (2015) 1 Nordic Tax J 34 (discussion of which rule of the Vienna Convention on the Law of Treaties justifies usage of OECD Commentaries in interpretation of double tax treaties, and the implications of this). However, it is still contended by this author that, as a more general trend, discussion has tended to focus on specific jurisdictions' domestic laws rather than looking at the interaction of rules as a global framework, thus missing key parts of the overall picture.

the fact that many tax lawyers speak of "cross-border" elements to their practice, often avoiding the use of the label "international" to describe such instances.[44] Yet international tax law governs interactions between states, and is based heavily upon treaties: it could not be more international in character. Thus, concepts borne of PIL are just as fundamental to the understanding of international tax law as those from domestic tax law, and should be considered to carry much weight in international tax disputes.

2.2. "Jurisdiction"

The first step of any analysis should be to seek to define clearly the subject of discussion. Although the term 'jurisdiction' is one of instant familiarity for any legal scholar or practitioner, it does not bring forth a particular or specific definition. Rather, jurisdiction, though the subject of an overwhelming quantity of academic research, remains a relatively abstract concept when considered from the point of view of general international law; this is because it tends to take on a different content depending on the area of substantive law from which it is approached.[45] At minimum, however, it can be agreed that jurisdiction is concerned with the competence to create and apply legal norms. To discuss jurisdiction is to address not just the ability of a body to exercise legal power, but also, perhaps most importantly, the limits that exist on that competence. It is at once an enabling device, and a method of restricting the actions of states.

Further, it should be noted that jurisdiction is not one-dimensional; it functions in several different aspects, and certain elements of jurisdiction are treated differently for the purposes of PIL. Traditionally, jurisdiction has been divided by scholars into three dimensions: prescriptive, enforcement, and adjudicative.[46] It is worth noting that contemporary jurisdiction also has a functional aspect, though this element of jurisdiction is outside the scope of this thesis.[47]

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[44] Reuven Avi-Yonah, 'International Tax as International Law' (2004) 57 Tax L Rev 483, 483.

[45] Stephen Allen et al. (eds) *The Oxford Handbook of Jurisdiction in International Law* (OUP, 2019) 4.

[46] Cecil Olmstead, 'Jurisdiction' (1989) 14 Yale J Int'l L 468, 468.

[47] Functional jurisdiction is mainly used in the context of the law of the sea, where it takes on both prescriptive and enforcement elements. See Cedric Ryngaert 'The Concept of Jurisdiction in International Law' in Orakhelashvili A. (eds) *Research Handbook on Jurisdiction and Immunities in International Law* (Elgar, 2015), 59-60.

Prescriptive jurisdiction is concerned with the competence to make laws that are applicable to those a body governs, in other words the ability of a body to regulate activity; it is exercised through executive, legislative or judicial means.[48] In the context of international law, therefore, this is the authority of a state to make a rule of law, through the use of domestic processes. On the other hand, enforcement jurisdiction is, as the name suggests, the ability of a body to apply those laws it has prescribed to its subjects or those within its sphere of influence. It is a state's competence to 'enforce or compel compliance … with its laws or regulations, whether through the courts or by use of executive, administrative, police, or other nonjudicial action'.[49] Such non-judicial action includes the use of armed force, although international law has developed so as to very strictly limit a state's jurisdiction to use force, such that it may only do so in specific cases of self-defence.[50] Enforcement jurisdiction also encompasses the punishment of non-compliance with laws. Finally, adjudicative jurisdiction refers to the ability of a state to carry out judicial proceedings, whether civil or criminal. This aspect of jurisdiction refers therefore to the reach of the courts, specifically, rather than the laws of the state. It is the question of whether a court may exercise its jurisdiction over a particular conflict.

Though most discussion in the context of this thesis will generally apply to all aspects of jurisdiction, the distinction between them is helpful in analysis of the doctrine. It is considered by this author to be especially relevant in the context of international tax law, as will be pointed out in argument further on in this chapter. It should be noted, however, that this tripartite approach to jurisdiction is not the definitive view of jurisdiction; it may be useful in the context of theoretical debate, but it is certainly not the only way in which to approach jurisdiction and courts do not always distinguish between the three aspects.

2.2.1. Westphalian Sovereignty

Traditionally, jurisdiction has had an intrinsic connection with the concept of sovereignty. On the domestic level, sovereignty functions to legitimise the state's exercise of power, and to indicate the ultimate authority in any context. Yet, once one looks to the international level, all states hold equal sovereignty; if every state is sovereign and thus the

[48] Olmstead (no 46), 48-9.
[49] Restatement (Third) of the Foreign Relations Law of the United States (1987), s 401(c).
[50] Charter of the United Nations (1945) art. 2(4).

ultimate authority, then simultaneously no state is the ultimate authority. Thus, where sovereignty cannot be turned to when attempting to weigh conflicting claims, an alternative tool is needed. This tool has taken the form of the doctrine of jurisdiction. At its essence, therefore, jurisdiction in international law is concerned with a fundamental function of PIL: "the function of regulating and delimiting the respective competences of States".[51] Nevertheless, to fully understand the concept of jurisdiction, it is necessary to some extent to refer to the concept of sovereignty and its history.[52]

The concept of sovereignty is far from static; its exact meaning and content has fluctuated throughout the history of international law. Sovereignty began as a term encompassing the rights of the crown, which were seen to be vested within a particular person. As the modern state developed, however, these sovereign rights began to be conceptualised less as an attribute of a particular person, and more as a separate, indivisible, body of rights of which the sovereign, as a consequence of their position, held custody.[53] This began the process of separating the idea of the 'state' from that of the government, one step closer to the idea of sovereign state that exists in today's international law. This idea of the sovereign state was arguably fully realised by Hobbes in his 1951 work Leviathan, whose writings made it possible to clearly conceptualise the state as an entity of its own, distinct from, and operating above, its subjects.[54] Once this theoretical path had been traversed, it became clear to legal scholars that sovereignty vested in the state itself.

[51] F Mann, 'The Doctrine of Jurisdiction in International Law' (1964) 111 *RCADI* 1, 15.

[52] The concept of sovereignty is the subject of countless works of academic writing, and thus will only be addressed briefly here. For more detailed historical development of the concept, see Kaius Tuori, 'The Beginnings of State Jurisdiction in International Law Until 1648' in Stephen Allen (eds) *The Oxford Handbook of Jurisdiction in International Law* (OUP, 2019), and Stephane Beaulac, 'Emer de Vattel and the Externalisation of Sovereignty' (2003) 5 *Journal of the History of International Law* 237.

[53] Bodin, for example, was an influential force in the sixteenth century with his view of sovereignty as a body of rights that exists independently of a king or queen, and is simply in the custody of such a ruler at a given time, Jean Bodin, *The Six Bookes of a Commonweale* (London: Impensis G. Bishop, 1606).

[54] Stephen Neff, *Justice Among Nations* (Harvard University Press, 2014) 168-9. ("[I]t now became possible to think, more clearly than before, of a state as an entity that was quite distinct from its members— and, more importantly, as an entity with rights, duties, and interests of its own, which are different from, and superior to, those of its members").

When considering sovereignty in its connection to jurisdiction, a particularly significant moment in history is the Peace of Westphalia in 1648[55]; this event been hailed as "the beginning of the modern state system".[56] Westphalia is often credited as being the beginning of the view of the international community as an association of independent and equal sovereign states. The underlying doctrines that support such a conception have come to form the content of a particular form of sovereignty, usually referred to as 'Westphalian sovereignty'. This view of sovereignty is inextricably connected with the idea that a state is absolutely supreme within its territorial limits, and may exercise its powers as it sees fit. A natural consequence of such a position is the principle of non-intervention, which holds that a sovereign state should be free of outside influence on the way in which it exercises its sovereignty within its territory. The roots of jurisdiction therefore lie in this view of the international legal order, creating "a system in which legal jurisdiction is congruent with sovereign territorial borders".[57]

2.2.2. The Territoriality Principle

Westphalian sovereignty, with its heavy emphasis on territory and the principle of non-interference, tied the question of jurisdiction very closely to the territory of the state. Such equation of jurisdiction with the territory of the state created the most uncontested basis of jurisdiction, known as the 'territoriality principle'. The territoriality principle essentially embodies the idea that within a state's territory, its jurisdiction is absolute. Any limits imposed upon territorial jurisdiction are those that have been accepted by the state upon itself, either through enactment of constitutional limits or through the negotiation of treaties.

Following the Peace of Westphalia, sovereignty can be envisaged within the framework of an internal-external dichotomy. Internal sovereignty refers to the power exercised by a state over its own territory; pursuant to the territoriality principle, internal sovereignty is considered to be

[55]Peace negotiations for the Thirty Years War led to the agreement of two treaties, the Treaty of Osnabrück (between Sweden, the Holy Roman Empire and the German princes) and the Treaty of Münster (between France, the Empire, and the German princes). These treaties created a new constitutional order which confirmed the powers of the German princes to act independently of the Holy Roman Empire. For more detail, see Neff (no 54), 139-141.
[56]*Ibid*, 140.
[57]Stephane Beaulac, 'The *Lotus* Case in Context' in Stephen Allen et al. (eds) *The Oxford Handbook of Jurisdiction in International Law* (OUP, 2019) 43.

absolute. Thus the question of jurisdiction within a state's territory is easily answered: such jurisdiction is absolute. The external side to sovereignty is premised upon Vattel's writings on the relations between states. External sovereignty constitutes the idea that states are, as a consequence of their sovereignty, independent and equal, and thus may not be constrained by rules of international law other than those that they have voluntarily accepted.[58] External sovereignty relies to some extent on the principle of non-intervention, which has historically been considered sacrosanct.[59] This principle has two sides to it: it embodies the idea that a state's domestic affairs should not be interfered with by other states, whilst at the same time requiring that a state does not overreach its jurisdiction and interpose itself in the affairs of other states. Therefore the question necessarily arises, when do states have the jurisdiction to act extraterritorially? If limits on a state's external sovereignty must be voluntarily accepted, do such limits exist in regard to jurisdiction?

2.2.3. The *Lotus* Case

To answer this question, it is necessary to turn to the Lotus case, which remains deeply influential in the field of jurisdiction.[60] The case concerned the collision of two ships in the part of the Aegean Sea which constituted the high seas; a French vessel, the Lotus, caused a Turkish ship to capsize, killing several people. Once the ship reached Turkish shores, criminal proceedings were initiated against the French captain by Turkish authorities. France insisted that Turkey did not have criminal jurisdiction in this situation, and as such the criminal proceedings constituted a breach of international law. Both states agreed to bring the dispute before the Permanent Court of International Justice for resolution.

The Lotus case therefore concerned the exercise of jurisdiction over a non-national, for events which took place outside of the state's territory.[61] The court split six to six in judgement, with the president's

[58]Emmerich Vattel, *The Law of Nations* (London, 1834) ("It is an evident consequence of the liberty and independence of nations, that all have a right to be governed as they think proper, and that no State has the smallest right to interfere in the government of another. Of all the rights that can belong to a nation, sovereignty is, doubtless, the most precious, and that which other nations ought the most scrupulously to respect, if they would not do her as injury.")
[59]Ryngaert (no 47), 53.
[60]*SS Lotus (France v Turkey)* [1927] PCIJ Series A, No. 10 ["*Lotus*"].
[61]It should be noted that flag jurisdiction had not yet been developed at this

deciding vote coming down on the side of Turkey. The court stated, in its now famous dictum:

> "International law governs relations between independent States. The rules of law binding upon States therefore emanate from their own free will as expressed in conventions or by usages generally accepted as expressing principles of law and established in order to regulate the relations between these co-existing independent communities or with a view to the achievement of common aims. Restrictions upon the independence of States cannot therefore be presumed."[62]

This suggests that, where no prohibitive rule to the contrary can be found, a state is free to act as it wishes. Such conclusion would seem to suggest that under international law, a state's extra-territorial jurisdiction is entirely unlimited, except where a specific rule to the contrary exists. However, such an approach would arguably cause chaos on the international stage, as well as being in direct conflict with the principle of non-intervention. The court immediately follows with a qualification:

> "Now the first and foremost restriction imposed by international law upon a state is that—failing the existence of a permissive rule to the contrary—it may not exercise its power in any form in the territory of another State. In this sense jurisdiction is certainly territorial; it cannot be exercised by a State outside its territory except by virtue of a permissive rule derived from international custom or from a convention."[63]

Here, the distinction made above between prescriptive and enforcement jurisdiction becomes significant. The court's wording refers to a state's exercise of power outside territorial borders; this appears to refer to enforcement jurisdiction specifically, thus suggesting that the requirement of a permissive rule applies only in the case of enforcement jurisdiction and not in the case of prescriptive jurisdiction. This would mean that in theory international law imposes no restrictions on the reach of a state's legislation, but that same state cannot carry out its enforcement jurisdiction outside of its territory unless a particular rule permits it to do so. Such distinction in the limits on jurisdiction may be seen in the area of criminal law. A state may criminalise, for example, the consumption of drugs by its nationals; if a national consumes drugs in the territory of another state, the nationality state may not enter such state to arrest the national or otherwise

point, and thus the court had to decide on the basis of traditional jurisdiction principles.

[62] *Lotus* (no 60), 18 (emphasis added).

[63] *Ibid*, 18-9 (emphasis added).

enforce its criminalisation of drug consumption. However, the legislation of the nationality state criminalising such act may still apply to the national, since prescriptive jurisdiction is not tied to territory. Thus if the national returns to their nationality state, such legislation may be enforced against them once the national state regains its enforcement jurisdiction.[64]

The legitimacy of this understanding of the Lotus case is supported by the rest of the majority judgement, which later states:

> "It does not, however, follow that international law prohibits a State from exercising jurisdiction in its own territory, in respect of any case which relates to acts which have taken place abroad, and in which it cannot rely on some permissive rule of international law. Such a view would only be tenable if international law contained a general prohibition to States to extend the application of their laws and the jurisdiction of their courts to persons, property and acts outside their territory, and if, as an exception to this general prohibition, it allowed States to do so in certain specific cases. But this is certainly not the case under international law as it stands at present. Far from laying down a general prohibition to the effect that States may not extend the application of their laws and the jurisdiction of their courts to persons, property and acts outside their territory, it leaves them in this respect a wide measure of discretion which is only limited in certain cases by prohibitive rules."[65]

What is clear from this excerpt is that prescriptive jurisdiction can be extended beyond the bounds of territory, where a prohibitive rule to the contrary does not exist. It is only enforcement jurisdiction that should be considered tied to the territoriality principle. Such a reading is logical even when considered in the face of the principle of non-intervention, since it is enforcement that requires a state to interfere with another state's sovereignty. Simply expanding the scope of legislation does not in itself cause conflict with the principle. However, in contexts such as taxation and corporate regulation, a state is unlikely to extend its

[64] One example is the recent arrest of Chun Woo-won, a South Korean national, for drug offences on his re-entry into South Korea on 28th March 2023. The alleged drug use happened abroad, yet South Korea claims jurisdiction over its citizens even when they are outside the country. This is therefore an example of legislation being applied extra-territorially, through prescriptive jurisdiction, but enforcement only being possible on the basis of territorial jurisdiction. Jung-youn Lee, 'Ex-president's grandson arrested over drug use as he enters Korea' (Korean Herald, 28 March 2023) <https://www.koreaherald.com/view.php?ud=20230328000036> accessed 23 April 2023.

[65] *Lotus* (no 60), 19.

legislation past the point of being able to enforce it. Thus, the question of extra-territorial exercise of enforcement jurisdiction remains significant.

2.2.4. Extra-territorial Exercise of Jurisdiction

Following the decision in *Lotus*, when it comes to the exercise of enforcement sovereignty outside of a state's territory, a permissive rule is required. Besides territory, which other permissive rules of jurisdiction exist within PIL?

In 1935, Harvard Law School published its Draft Convention on Jurisdiction with Respect to Crime, the conclusion to its codification of international law project.[66] This Convention sought to identify the bases on which "a more or less extensive jurisdiction is claimed by States".[67] It identified, beside territoriality, four other principles. The first of these was nationality. This principle draws upon the idea of the state as "a group of persons, wherever located, who are subject to a common authority that accompanies nationality".[68] This principle allows the extension of jurisdiction to regulate the activities of a state's nationals abroad, and as such is also referred to as the "active personality principle". As a grounds of jurisdiction, it is most often invoked in the context of international family law and in criminal law. The question of whether a particular person is a national is usually left to be determined under domestic law.[69] When a state does make a claim of nationality, another state may determine whether such claim should be accepted through the use of the "genuine link" test.[70]

Grounding a jurisdiction claim on the basis of the nationality of the victim was also put forward as a possible permissive link. However, the

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[66]Draft Convention on Jurisdiction with Respect to Crime, reproduced in (1935) *American Journal of International Law* 29 Supp 1. The project consisted of three phases, including draft conventions for issues such as nationality, diplomatic privileges and immunities, and the law of extradition, among others.
[67]*Ibid*, 445.
[68]Allen (no 45), 6.
[69]Convention on Certain Questions relating to the Conflict of Nationality Laws (1930) ["Hague Convention"], article 1: "It is for each State to determine under its own law who are its nationals".
[70]The 'genuine and effective link' doctrine originated in the judgement of the International Court of Justice in *Nottebohm Case (Liechtenstein v Guatemala)* [1955] ICJ 1; the court held that Guatemala was under no obligation to recognise the status of national conferred upon Nottebohm by Liechtenstein, since Nottebohm had no genuine link with that country.

so-called "passive personality principle" is controversial, and traditionally has not been accepted by all.[71] Exercising jurisdiction on such premises often signals that the nationality state has no faith in the legal system of the state in which the crime occurred, which amounts to a significant political or diplomatic statement.[72] Further, some scholars argue that exercising jurisdiction on the basis of the passive personality principle amounts to "an excess of jurisdiction".[73] Indeed, the Harvard Draft Convention also chose not to endorse this principle.[74] However, more recently the approach of states has changed, with passive personality jurisdiction becoming much more widely accepted in the case of certain crimes such as terrorism.[75] The United States, for example, now recognises jurisdiction over foreign murders of US nationals and acts of terrorism harming US nationals.[76] The United Kingdom also now recognises the passive personality principle as grounds for prosecution of terrorist acts.[77]

The third principle identified as providing a basis for jurisdiction is the protective principle. This principle holds that states can exercise jurisdiction over activities that endanger the state, even if such activities take place outside of the territory of the state.[78] Examples of such acts include the printing of counterfeit currency, or espionage.[79] Hence, even if the perpetrators are non-nationals, a state may claim jurisdiction on the basis of protection. States' approach to this grounds of jurisdiction has shifted somewhat over time, such that it is no longer defined by the crimes to which it applies and instead by the legal interests which it protects; these interests include a state's security, and its credit or money.[80]

[71]Allen (no 45), 6; The United States, for example, consistently opposed the application of passive personality jurisdiction where the perpetrator was a US national, and even where the victim was a US national. One example of this is a 1906 case where in the US refused to prosecute a French national for killing a US national in China – see Christopher Blakesley, 'A Conceptual Framework for Extradition and Jurisdiction over Extraterritorial Crimes' (1984) Utah L Rev 685, 689.
[72]Gerhard Werle and Florian Jessberger, *Principles of International Criminal Law* (OUP 4th edn., 2020), 95.
[73]Allen (no 45), 6.
[74]Harvard Draft (no 66), 579.
[75]Kenneth Gallant, *International Criminal Jurisdiction* (OUP, 2022) 441.
[76]For example, United States 18 USC secs 2332(a): "Homicide.- Whoever kills a national of the United States, while such national is outside the United States…".
[77]UK Terrorism Act (2000) section 63C: "Terrorist attacks abroad on UK nationals, residents and diplomatic staff etc : jurisdiction".
[78]Gallant (no 75) 409.
[79]*Ibid*, 409.
[80]*Ibid*, 438.

The final recognised principle of jurisdiction is the universality principle. Universal jurisdiction entitles any state in the international global community to prosecute a person suspected of having committed certain international offences, regardless of the nationality of any party involved or the location of the crime. The underlying rationale of such jurisdiction is that the crimes prosecuted are so heinous that they constitute a concern to the international community as a whole; therefore, a state's jurisdiction under the universality principle is derived from the crime itself.[81] The international crimes to which universal jurisdiction applies under customary international law include crimes such as genocide, war crimes and piracy.[82]

Having sketched out a solid picture of jurisdiction and its recognised grounds in PIL, it is now time to turn the discussion to the context of international taxation law.

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[81]Werle (no 72), 96.

[82]Genocide: It is generally believed that customary law has developed so as to recognise the universality principle as a basis for prosecution of genocide. The right of a state to prosecute genocide on the grounds of universal jurisdiction has been explicitly expressed by multiple courts, including the Israeli Supreme Court in *Eichmann* (1962) and more recently the Spanish Constitutional Court in the *Guatemala Genocide Case.* For more detail, see Amina Adanan, 'Reflecting on the Genocide Convention in its Eighth Decade' (2021) *Journal of International Criminal Justice* 1039, 1055; *Attorney General of the Government of Israel v Eichmann* (1962) Israel Supreme Court published in (1968) 36 *International Law Reports* 277; *Guatemala Genocide Case* (2005) Constitutional Tribunal (Second Chamber) judgement no. STC 237/2005, unofficial translation <https://ihl-databases.icrc.org/en/national-practice/decision-no-237-guatemala-genocide-case-constitutional-tribunal-26-september-2005> accessed 4 July 2023.
War crimes: Geneva Convention (1949) article 49: "Each High Contracting Party shall be under the obligation to search for persons alleged to have committed, or to have ordered to be committed, such grave breaches, and shall bring such persons, regardless of their nationality, before its own courts."
Piracy: United Nations Convention on the Law of the Sea (1982) article 105: "On the high seas, or in any other place outside the jurisdiction of any State, every State may seize a pirate ship or aircraft, or a ship or aircraft taken by piracy and under the control of pirates, and arrest the persons and seize the property on board. The courts of the State which carried out the seizure may decide upon the penalties to be imposed, and may also determine the action to be taken with regard to the ships, aircraft or property, subject to the rights of third parties acting in good faith."
For more detail on more contemporary use of universal jurisdiction, see Maximo Langer, 'Universal Jurisdiction is Not Disappearing' (2015) 13 *Journal of International Criminal Justice* 245, 246.

2.3. Jurisdiction in the Context of International Tax Law

International tax law is, at its most fundamental, attempting to answer the question of jurisdiction. The power to tax is an inherent, and uncontested, manifestation of sovereignty and thus each sovereign state holds this power. It is also perhaps one of the most jealously guarded aspects of a state's sovereignty, since it is taxation which brings in revenue for the purposes of state-building. However, for the power to tax to manifest itself in a right to tax, there is an additional factor required: the jurisdiction to tax (fiscal jurisdiction). It is with the question of how each state's competing rights to tax should be divided on the international scale that international taxation law is concerned.

The discussion of jurisdiction to tax has attracted a lot of attention from scholars, particularly in the context of the exposure of the current international taxation system's flaws. However, it remains an extremely unsettled area of debate, with no clear answer or consensus emerging as to how fiscal jurisdiction should be regarded. Those views on the topic that have been put forth can be organised, roughly, into two opposing camps: those that believe international law imposes no limits at all on a state's prescriptive jurisdiction to tax, and those that maintain the requirement of a sufficient link between the state and the object of taxation.[83] It should be kept in mind that, moving forward, this thesis will be discussing jurisdiction in its prescriptive aspect, unless specifically stated.

2.3.1. No Limits

The first school of thought holds that PIL imposes no overarching limits upon states' jurisdiction to tax. Thus, besides those that states take on themselves in tax treaties, there are no limits upon a state's fiscal jurisdiction. Monsenego, for example, states that "no internationally accepted minimum connection is required from and binding on states to exercise jurisdiction to prescribe in the field of tax law".[84] From this point of view, the nexus rules in double taxation treaties are simply imposed for the purpose of the treaty and do not derive from a pre-existing general rule in international law; nor have these nexus rules

[83] Following the categorisation put forward by Christians (no 14) 27-30.
[84] Jerome Monsenego, 'Taxation of Foreign Business Income within the European Internal Market' (IBFD 2012) 67.

reached the point of being recognised as customary international law.[85]

The *Lotus* case is invoked to support this argument, since, as discussed above, it specifies the prohibitive character of international law in regards to prescriptive jurisdiction: where no prohibitive rule exists, a state is free to exercise its sovereignty within its own discretion. Holders of the 'no limits' point of view argue that as no prohibitive rule exists in regards to fiscal jurisdiction, there are thus no limits on how a state may exercise it.[86] Arnold goes so far as to state that "there is no overriding international law of taxation arising either from the customary practice of sovereign states or from actions of some international body such as the UN or the OECD", and that the majority of tax laws are not international in character at all.[87]

2.3.2. Sufficient Link

In contrast, many scholars argue the existence of a rule requiring a sufficient link between the taxpayer and the state that is trying to exercise its fiscal jurisdiction. Rust, for example, contends that "[c]ustomary international law … prevents states from taxing when there is no genuine link between the income and the taxing state".[88] This is sometimes called the doctrine of close connection, or the nexus rule.[89] The consensus among this second group of authors appears to be that taxation where there is no link between the state and the person or income subject to the tax is outside of a state's jurisdiction.[90] For instance, Hongler states that "legally prohibited extraterritorial taxation is given if there is no link to a certain jurisdiction and such jurisdiction nevertheless levies income taxes".[91] The bases usually given for fiscal jurisdiction are a personal link with the state, through factors such as residence or place of incorporation, and a territorial link, based on the

[85] Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (CUP, 2011) 24.
[86] Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (CUP 2nd ed., 2013) 307.
[87] Brian Arnold, *International Tax Primer* (4th ed., Kluwer 2019) 175.
[88] Alexander Rust, 'Double Taxation' in Rust (ed.) *Double Taxation Within the European Union* (Kluwer 2011) 3.
[89] Christians (no 14), 29.
[90] Roy Rohatgi, *Basic International Taxation, Volume 1: Principles of International Taxation* (2nd ed., Richmond 2005) 14-15 ("'Connecting factors' give a State the right to tax. These connecting factors link the taxpayer personally to a particular tax jurisdiction.").
[91] Peter Hongler, *Justice in International Taxation: A Normative Analysis of the International Tax Regime* (IBFD, 2019) 80.

source of income.[92] These mirror, in a way, the territoriality and nationality principles from general PIL, though, as will be discussed further on in this chapter, they have taken on a much more expansive meaning under the umbrella of international taxation law.

From where does the prohibitive rule requiring a sufficient link in order for a state to exercise prescriptive jurisdiction derive? This is perhaps the most important question to answer in order to put forward the close connection doctrine as a valid approach; in fact, one of the main criticisms leveled against the sufficient link rule is that supporters do not put forward satisfactory arguments for legal sources which support the existence of such a rule.[93] This thesis, however, does not agree that that is the case.

Traditionally, the sources of international law are considered to be those laid out by Article 38(1) of the Statute of the International Court of Justice.[94] Pursuant to this article, there are three primary sources of international law: treaties, customary international law, and general principles of law. The first possible source for a genuine link rule is therefore treaty law. It is clear that that double tax treaties put in place limitations on the treaty partner states' exercise of jurisdiction; the purpose of such treaties is, after all, to coordinate taxation and prevent both states from exercising their jurisdiction over the same income simultaneously. The OECD Model Tax Convention, for instance, assigns taxation rights depending upon the residence of taxpayers or the source

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[92] "[I]f there is a sufficient connection (genuine link or nexus) between the taxing jurisdiction and the taxpayer (nationality, residence) or between the taxing jurisdiction and the taxable transaction, assets or income (situs, source)" in Guilhermo Teijeiro, 'Opening Pandora's Box in the International Tax Field: Double Taxation' (2015) 42:5 *Tax Plan Int'l Rev* 3.

[93] For instance, Christians argues that neither customary international law nor general principles of international law provide for a sufficiently clear concept of nexus requirement, such that it cannot be considered legally binding on states; "all of the concepts described in the literature as common tax law norms or practices are at their core vague and under-defined, and therefore unable to create international legal obligations or impose prohibitions about what states can do" in Christians (no 14), 38.

[94] Statute of the International Court of Justice, article 38(1): "The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply: a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states; b. international custom, as evidence of a general practice accepted as law; c. the general principles of law recognized by civilized nations; d. subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law."

of income.[95] However, this thesis is in agreement with Christians, that treaties cannot be the source of a more general restriction upon tax jurisdiction.[96] Although the majority of double tax conventions are modeled after the OECD Model Tax Convention, treaty law cannot be binding outside of the treaty system itself and therefore cannot constitute the basis of a general prohibitive rule. Thus the nexus rule does not find its source in treaties. This thesis disagrees, however, with Christians' assertion that treaties cannot be used as evidence of states' abiding by an existing general international law rule.[97] The fact that the vast majority of treaties consider a residence-based or source-based link a necessary requirement for jurisdiction to tax to exist, and such language has consistently been used (and remains in use under the new Two Pillar Solution) should be taken as evidence that states do consider the close connection doctrine to apply to them, in some capacity. This point will be elaborated further in connection to the idea of customary international taxation law (CITL).

If the origin of the nexus requirement is not to be found in treaty law, then the next possible option is customary international law. For the formation of customary international law, it is traditionally accepted that two elements are required: general and continuous state practice, and *opinio juris*.[98] Scholars differ in their approach to the relative weight of each factor, with modern writers tending to give more emphasis to *opinio juris* than those taking the traditional approach.[99] Regardless, it is clear that both elements must be present in order for a norm to be capable of constituting customary international law. This thesis argues that the nexus requirement for jurisdiction to tax finds its source in customary international law, therefore taking in part the viewpoint

[95] Model Tax Convention (no 15), article 1(1) (Persons Covered): "This Convention shall apply to persons who are residents of one or both of the Contracting States"; article 7(1) (Business Profits): "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 profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State."

[96] Christians (no 14), 31.

[97] *Ibid*, 31: "Treaties are not able to clarify jurisdictional boundaries because they tend to leave open the question of whether a specific agreement should be seen as introducing exceptions to general international law or, by contrast, voluntary limitations on the parties' sovereignty that did not exist prior to the agreement."

[98] Reuven Avi-Yonah, 'Does Customary International Tax Law Exist?' in Brauner Y. (eds), *Research Handbook on International Taxation* (Elgar, 2020) 2.

[99] Christians (no 14), 32.

propounded by Avi-Yonah.[100] Making such a claim requires proving that the majority of states not only act in unison, but also believe that they are legally bound to act in such a manner.[101] Avi-Yonah finds such evidence in the historical development of controlled foreign company legislation.

This saga began in the 1930s, when the United States began to consider imposing taxation on foreign-sourced income of foreign corporations controlled by US residents; at the time the US only imposed taxation on the basis either of domestic residence, or domestic source income. In 1937, the US adopted legislation taxing shareholders of Foreign Personal Holding Corporations (FPHCs).[102] This rule taxed the US shareholders on a deemed dividend, in contrast to the rule applied to Personal Holding Corporations (PHC), which were taxed at the corporate level. The fact that a different rule was applied to FPHCs shows that the US government considered the deemed dividend rule to be necessary to somehow provide a link for its tax jurisdiction, else it would have treated FPHCs and PHCs in the same manner. As Avi-Yonah points out, there was no controlling tax treaty at this time, seemingly suggesting that the US' feeling that its fiscal jurisdiction was limited to residence or source-based jurisdiction was the result of such practice by the majority of other states.[103] The deemed dividend rule was therefore clearly put in place in deference to the requirement of a sufficient link in order for jurisdiction to tax to exist. Even so, this legislation marked a significant expansion of the US' residence-based taxation.

Following the US' lead, other states also began to adopt similar

[100]Avi-Yonah first made the case that the arm's length standard, principle of non-discrimination, jurisdiction rules, double tax relief via credit or exemption, income categories and controlled foreign corporation legislation form part of "customary international tax law" in Avi-Yonah, (no 44); he later restricted this theory to four norms, jurisdiction to tax being one of them, in Avi-Yonah (no 98). This thesis will only speak to the question of jurisdiction to tax as CILT, hence the qualification of "in part".

[101]*North Sea Continental Shelf Cases*, Reports of Judgements, Advisory Opinions and Orders (1969) 45: "Not only must the acts concerned be a settled practice, but they must also be such, or be carried out in such a way, as to be evidence of a belief that this practice is rendered obligatory by the existence of a rule requiring it … The States concerned must feel that they are conforming to what amounts to a legal obligation. The frequency, or even habitual character of the acts is not in itself enough."

[102]FPHCs were defined as foreign corporations controlled by five or fewer US individual residents, with income that was over sixty percent passive. The definition of PHCs, on the other hand, was identical but for the fact that they were domestic corporations.

[103]Avi-Yonah (no 98), 3-4.

provisions.[104] As more states brought in CFC provisions, they began to drop the deemed dividend rule, suggesting that the content of the jurisdiction rule in international law had changed to no longer require such a work-around. This is yet more evidence in favour of the existence of a custom, since customary international law principles are able to develop and expand in such a way. A traditional example of such a process of change is jurisdiction over the continental shelf, famously claimed by the US in the 1945 Truman Declaration.[105] There too what was once considered to breach a rule of customary international law met no condemnation from states and was instead adopted by them, leading to a change in the content of the law. Thus, it is put forward that the development process of CFC legislation demonstrates both a general state practice requiring some form of link to the subject of taxation (which in the case was satisfied by the deemed dividend theory, before the rule as considered to have expanded) and opinion, at least of the US, that it was bound by a jurisdictional limit. This therefore serves as evidence for the existence of a jurisdiction limiting rule in customary international law.

A second interesting argument advanced by Avi-Yonah in support of the existence of CITL in general is that of the case of arbitration between Vodafone and the Government of India. This case involved a dispute over treatment for the purposes of tax of capital gains from a 2007 acquisition by Vodafone.[106] In the course of proceedings, Vodafone had argued that customary international law applies, and that the tax nexus requirement under CITL was not satisfied at the time of the transfer. This is because the transfer in question took place outside of India. The tribunal ruled in Vodafone's favour, despite explicit (yet retroactive) Indian legislation existing to the contrary; since the judgement has not been released, however, it is not possible to know what weight, if any, the tribunal gave to Vodafone's CITL-based argument. Despite this, the case remains evidence that the concept of CITL in regards to jurisdiction to tax is not confined only to academic discussion, but has been raised in practice also.

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[104] Canada (1975), Japan (1978), France (1980), and the United Kingdom (1984), among others.

[105] Proclamation 2667 – Policy of the United States With Respect to the Natural Resources of the Subsoil and Sea Bed of the Continental Shelf (1945): "[T]he Government of the United States regards the natural resources of the subsoil and sea bed of the continental shelf beneath the high seas but contiguous to the coasts of the United States as appertaining to the United States, subject to its jurisdiction and control."

[106] *Vodafone International Holdings BV v India (I)* (2014) PCA Case No. 2016-35; Avi-Yonah (no 98), 10.

Avi-Yonah's theory has met with more criticism than it has support. Christians is quick to dismiss the possibility of CILT, pointing out the existence of differences between states' tax systems, particularly in the way states define residence and source in regards to taxation.[107] It is true that the International Law Association has stated that "different States must not have engaged in substantially different conduct, some doing one thing and some another".[108] This suggests that differences in conduct between states, such as differences in definition of key terms, do have an effect upon the question of whether customary law exists. Thus Christians' argument does have merit, in its concerns over lack of uniformity in state practice. However, this thesis would argue that, even so, such a position is too hasty, and does not consider the role that the OECD has had in harmonising states' approaches towards taxation over the past decades. Considering that over 3000 tax treaties exist modeled on the OECD Model Tax Convention, and thus the majority of states have adopted the requirement of a sufficient link to ground a claim to jurisdiction, it is argued by this thesis that differences in the exact content of the nexus should not be fatal to the possibility of existence of a rule requiring such a nexus.

To clarify, this thesis does not argue that the content of the nexus requirement constitutes customary international law. Rather, it puts forward the proposition that the requirement of a sufficient link with the country attempting to impose taxation is a rule of customary international law, but the content of that link remains open to state discretion. This is supported by Gadžo, who argues that states retain a wide discretion in determining the content of the nexus.[109] The fact that a majority of states appear to use residence- and source-based jurisdictional links does not go far enough to overcome the criticisms made above, that such concepts are not uniformly applied and therefore cannot constitute consistent state practice. However, what it does do is prove that the majority of states believe their jurisdiction to tax to be limited to cases where they can prove the existence of a link. Thus, it is not too far of a leap to state that customary international law requires the existence of a link of some form.

[107] Christians (no 14), 35.
[108] International Law Association, *London Conference Statement of Principles Applicable to the Formation of General Customary International Law* (2000) 21.
[109] Stjepan Gadžo, *Nexus Requirement for Taxation of Non-Residents' Business Income: A Normative Evaluation in the Context of the Global Economy* (IBFD 2018) 209; see also Harris (no 18), 62: "Customary international law is particularly vague in this area, but it is, perhaps, appropriate to suggest that it requires some sort of connecting factor, some link to a country for the country to have a recognisable jurisdiction to tax."

A further criticism raised is that international tax law as a whole mainly exists in the form of bi-lateral treaties, and thus cannot support the existence of general customary international tax law. The argument is that bilateral tax treaties are better seen as "coordination devices"; states make use of the principles developed by the OECD Model Tax Convention for reasons of convenience and self-interest, rather than because they believe themselves to be legally bound by such principles.[110] However, the strength of such a criticism is undermined when considering recent developments in international taxation. Measures such as the IF and BEPS Action Plan have shown a strong shift towards multilateral cooperation, and unified approaches to taxation.[111] More specifically, the Multilateral Instrument (MI) that entered into force in July 2018, with 137 jurisdictions signing on, provides strong evidence that states are prepared to approach taxation in a unified manner.[112] The MLI allows states to swiftly modify bilateral taxation agreements; existing tax treaties that states wish to align with the BEPS Action Plan are listed by both treaty partners, and the listed treaty then becomes an agreement covered by the MLI.[113] In using the MLI, states have made a significant step towards completely harmonising existing tax agreements, and enacting unified reform in the future.[114] Such an approach moves the driving force behind international taxation law away from self-interest and towards collective benefit, which clears space for norms to be considered binding on the international community as a whole.

2.3.3. Which Approach?

It is the view of this thesis that the most desirable approach is the sufficient link requirement. In the case of enforcement jurisdiction, first

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[110] Dirk Broekhuijsen and Irma Valderrama, 'Revisiting the Case of Customary International Tax Law' (2021) 23 *International Community Law Review* 79, 89-90.
[111] *Ibid*, 103.
[112] Info Brochure (no 35) 6.
[113] *Ibid*, 3.
[114] As Magalhães notes, the amendment procedure included in the MLI provides an opportunity to involve non-OECD states (who are party to the MLI) in discussion of issues of international tax law, and thus increase global cooperation in this area; see Tarcísio Magalhães, 'The OECD Multilateral Instrument: Challenge or Opportunity of Multilateralism in International Tax?' in Joanna Wheeler (ed.), *The Aftermath of BEPS* (IBFD, 2020) 15 ("On the other hand, the inclusion of an amending procedure under a COP potentially represents a much-awaited opportunity to empower non-OECD member countries in global tax discourse").

of all, it is clear that the *Lotus* case imposes a general requirement of a permissive rule. Thus, a state certainly cannot enforce tax legislation that applies extra-territorially unless it can prove the existence of a genuine link. In the case of prescriptive jurisdiction, however, the *Lotus* case does not impose any restrictions. Yet, this should not be taken to mean that no restrictions exist. In fact, the position on prescriptive jurisdiction set out in *Lotus* has been criticised by a fair amount of commentators, including some International Court of Justice (ICJ) judges.

A major point of criticism is that the decision in Lotus reflects a time in which the Court was overly deferential to state sovereignty. In the *Kosovo opinion*, for example, Simma J states that the *Lotus* principle is "redolent of nineteenth-century positivism, with its excessively deferential approach to State consent".[115] International law has developed in such a way that this kind of deferential approach is no longer entirely appropriate, and the era of "laissez-faire in international relations" that *Lotus* represents "has been significantly overtaken by other tendencies".[116] Indeed, the Harvard Research project on international law suggested in its Draft Convention on Jurisdiction with Respect to Crime that a more restrictive approach should be required, for all aspects of jurisdiction, prescriptive, enforcement, or adjudicative.[117] Thus, the large space left for state discretion by the Lotus case should not be taken as a conclusive representative of current international law's approach to the issue. Increasing focus on community benefit, and movement away from the Westphalian notion of strict non-interference, means that the approach of international law to state discretion has become less lenient. Thus it is contended that the existence of a sufficient link requirement for a state to have jurisdiction to tax is not in conflict with the character of international law as a whole.

It should be pointed out that a state is unlikely to exercise prescriptive jurisdiction over subjects where it cannot then exercise enforcement jurisdiction so as to ensure compliance; this may be a practical limitation, rather than a legal one, but it is still a relevant limitation. Thus, even if the argument that a sufficient link is required for a state to

[115] *Accordance with International Law of the Unilateral Declaration of Independence in respect of Kosovo (Request for Advisory Opinion)* [2010] ICJ Rep 403.
[116] *Case Concerning the Arrest Warrant of 11 April 2000 (Democratic Republic of Congo v Belgium)* [2002] ICJ Rep 3, Higgins, Kooijmans and Buergenthal LLJ.
[117] Harvard Draft (no 66).

exercise prescriptive jurisdiction is not found to be convincing, the question of whether sufficient grounds exist for a state to exercise jurisdiction in the context of the changes suggested by OECD Pillar One and Two should not be dismissed. It is still extremely significant from an enforcement jurisdiction approach.

How then, is the sufficient link to be conceptualised? The main bases traditionally considered by ITL are those of residence and source, as put forward in alignment with the doctrine of economic allegiance.

2.4. Economic Allegiance Doctrine

Traditionally, the income tax system has been built upon the ability to pay principle, which holds that "one's tax burden should reflect one's ability to pay, where income is often used as a measure of an individual's ability to pay tax".[118] However, such a theory provides little help for the issue of jurisdiction, since it cannot differentiate which ability to pay should be considered in each jurisdiction.[119] In order to answer this question, the League of Nations commissioned four economists to look into the principles underlying tax jurisdiction; the committee submitted their Report on Double Taxation in 1923. Using benefits theory, the economists developed the doctrine of economic allegiance so as to pinpoint a basis for jurisdiction to tax.

Benefits theory holds that taxes "should be considered payments for services rendered by the state to the taxpayers, and so proportioned."[120] Prior to the twentieth century, taxation had been based primarily upon nationality, and thus a taxpayer was judged to be receiving benefits from a state on the basis of nationality and citizenship.[121] As the economists' report pointed out, such taxation was asserted on the basis of political allegiance between the state and the taxpayer; it was felt by the committee that for the purposes of tax liability internationally, political allegiance only had marginal relevance. Instead, the economists suggested the basis of economic allegiance,

[118]William Anderson, 'Money Grab: How the G20/OECD Inclusive Framework for Taxation Could Unnecessarily Disrupt Corporate Incentives and Misallocate Taxing Rights' (2022) 55 Vand J Transnat'l L 1051, 1076.
[119]Reuven Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (1996) 74 Tex L Rev 1301, 1305.
[120]Anderson (no 115), 1075-1076.
[121]Jaakkola, 'From the Governance of National Tax Systems to Governing Through European Taxation' in Johan Lindholm and Anders Hultqvist (eds) *The Power to Tax in Europe: Swedish Studies in European Law Volume 14* (Hart, 2023) 68.

which allowed material and economic factors to be taken into account, rather than the formal criterion of nationality. This new concept was in part similar to the idea of economic belonging (*wirtschaftliche Zugehörigkeit*) put forward by Schanz and developed by Blumenstein, which emphasised the territorial origin of income as an essential element.[122] The report followed economic belonging in this sense, determining territorial source of income to be an essential factor in economic allegiance. It also singled out the taxpayer's country of residence as important, likely due to the influence that nationality had had in the development of taxation to that point.

Thus, the doctrine of economic allegiance recognised the residence state of the taxpayer, and state in which the taxpayer's income was generated, as having a sufficient link to the taxpayer in order to ground jurisdiction to tax. The choice of these two bases for jurisdiction highlights the ever-present tension between ability to pay and benefits theory in taxation.[123] Source-based jurisdiction has been considered to have a closer link to the benefits that a taxpayer receives from the state, and thus reflects benefits theory.[124] In contrast, residence-based jurisdiction has been argued to better reflect ability-to-pay, since only the residence jurisdiction is able to take into account the taxpayer's worldwide income and therefore their complete 'ability to pay'.[125]

However, the doctrine did not answer the question of which state should yield their right to tax in order to avoid double taxation; for this purpose, the report developed the "first bite at the apple" rule.[126] This rule holds that the country in which income is generated (the source country) has the primary right to tax, and the state of residence is obligated to grant an exemption or credit for the relief of double taxation.[127] Taxation by the residence state will therefore only apply to income that the source jurisdiction chooses not to expose to taxation. As Avi-Yonah has pointed out, rather than being based upon any calculation of optimal allocation, the "first bite at the apple" rule is more practical in nature.[128] The source country is granted primary right to tax since it has the better ability to tax, having access to all the information needed to enforce such taxation if necessary.

[122] Jaakkola (no 121), 68.
[123] *Ibid*, 71.
[124] *Ibid*, 69.
[125] *Ibid*, 70.
[126] Avi-Yonah (no 98), 5.
[127] Avi-Yonah (no 44), 489.
[128] Avi-Yonah (no 119), 1306.

Residence-based taxation

Residence-based taxation provides a basis for fiscal jurisdiction where, as the name suggests, the taxpayer is a resident of the state. It is therefore taxation on the basis of a link between the taxpayer themselves and the taxing state. As a basis for jurisdiction, residence-based taxation at first glance loosely mirrors the nationality principle in general PIL; it has been claimed that residence-based jurisdiction "reflects the principle of the taxpayer's affiliation with a particular state … and the right of states to tax their own residents", in return for the benefits that a taxpayer receives from the state.[129] However, the definition of residence that has been adopted by most states is much wider than the understanding of nationality in PIL. In fact, it is so far expanded that many see residence-based jurisdiction as grounded in the territoriality principle, rather than the nationality principle.[130] In many jurisdictions, a tax residence requirement is satisfied simply by mere physical presence within the state, often for a period of time short enough to be calculated in days.[131] Bilateral tax treaties, and the OECD Model Tax Convention, tend to leave the definition of 'residence' to domestic law.[132] In regards to a corporation, the country of residence is usually considered to be the country of incorporation or the country from which the corporation is managed and controlled, with the former being the US approach and the latter the UK approach.[133]

Source-based taxation

The second basis of jurisdiction for corporate income tax under international tax law is where the source of income is within a state's territory; more specifically, this applies where activities giving rise to or producing income take place within the state's jurisdiction. Source-

[129]Micheal Lang, 'Source versus Residence: A Reinterpretation of the Principles of International Income Taxation in Light of Globalization' (2008) Virginia Tax Review.
[130]Reuven Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) *Harvard Law Review* ("residence-based taxation is based on the territoriality principle of international law, which grants each state the exclusive right to tax its own residents on their worldwide income").
[131]Avi-Yonah (no 44), 485.
[132]Harris (no 18), 80; Model Convention (no 15), article 4(1): "the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature …".
[133]Avi-Yonah (no 44), 486.

based taxation is therefore also grounded in the territoriality principle.[134] In order to identify which income arises from a particular jurisdiction, sourcing rules exist. These function to assign taxable activities, and the income derived therefrom, to the jurisdiction in which they occur. The traditional method that has been used is the permanent establishment method, as discussed previously in Chapter I. The main point to be kept in mind here is that the permanent establishment rules, as they currently exist, require some form of physical presence within the jurisdiction of the state, otherwise source-based jurisdiction does not arise.

2.5. Conclusion

This chapter has introduced the concept of jurisdiction in general PIL, so as to provide context for the discussion of jurisdiction in the more specific frame of international tax law. Jurisdiction is an inherent foil to sovereignty, both enabling a state's exercise of sovereign powers and limiting them. Historically, Westphalian sovereignty, with its emphasis upon territoriality and non-intervention, has had significant impact upon the development of jurisdiction and its limits. Thus jurisdiction remains closely connected with the idea of territory, a characteristic visible not just in general international law but also ITL.

It has been argued that international law does impose limits upon a state's jurisdiction to tax; these limits are two-fold. First of all, the *Lotus* principle makes it clear that, where a state wishes to exercise enforcement jurisdiction outside of its own territory, it must prove the existence of a permissive rule. This applies equally to the jurisdiction to enforce tax rules as it does to areas such as criminal law or investment law. Secondly, as regards prescriptive jurisdiction, the *Lotus* case does not impose any general prohibitive rule. However, it is the view of this author that a general rule requiring a sufficient link between the state wishing to exercise prescriptive tax jurisdiction and the taxpayer (also referred to as the nexus rule) arises from customary international law. Such argument is supported by Avi-Yonah's theory on customary international tax law, as well as the existing level of harmonisation due to the OECD's model literature, and an increasing tendency towards multilateral cooperation between jurisdictions on matters of taxation.

[134] Lang (no 129), "source-based taxation reflects the principle of territoriality, which grants a state the power to tax all income derived from within its borders".

Having made such argument, the possible bases of jurisdiction in international tax law were discussed. Based on the doctrine of economic allegiance, which has remained the theoretical basis since the 1920s, these are residence-based jurisdiction, and source-based jurisdiction. Significantly, both require some form of physical presence within the territory of the state exercising jurisdiction. Thus both bases of jurisdiction under international tax law maintain a significant connection with the principle of territoriality.

Going forward, this thesis will turn its focus to the recent OECD Two Pillar Solution, and analyse its validity from the perspective of jurisdiction. It is hoped that this chapter has provided a solid basis and understanding of jurisdiction, both in PIL and ITL, from which to begin such analysis.

Chapter 3. Pillar One's New Taxing Right and the Revenue Nexus

3.1. Introduction

This Chapter will look at Pillar One's Amount A in detail, from the point of view of jurisdiction. Though the proposal has, of course, been the subject of much discussion since its Blueprint was first delivered in October 2020, it is only a minority of scholars who have looked to address the question of its interaction with PIL norms. In fact, discussion of these taxation proposals from the perspective of PIL has been so sparse that Christians, for example, referred to arguments from this angle as "surprising". Much discussion of Amount A's new taxing right seems to centre around the issue of how to allocate taxing rights between countries in an equitable manner.[135] Yet, before worrying about the order of priority of taxing rights, the question of whether such taxing rights are legitimate needs to be addressed. Thus this author believes it is necessary to examine the jurisdictional basis of Amount A's new taxing right, and to determine whether such right, if it is indeed expanding the jurisdiction of market states to tax, is a legitimate expansion of jurisdiction.

As concluded in the last chapter, a permissive rule on extra-territorial jurisdiction to tax exists in the form of the genuine link requirement. Thus, in order for a state to exercise jurisdiction outside of its territory, it must be able to prove that there is a genuine link between the subject of taxation, and the state exercising a taxing right. This, as a norm of international law, applies equally in the case of Pillar One, and Amount A.

In the context of taxation of corporate income, the doctrine of economic allegiance has been used to develop two possible bases for jurisdiction: the residence of the taxpayer, and the location of the income. The first is residence-based jurisdiction, the latter source-

[135]See, for example, Matthias Bauer, 'Unintended and Undesired Consequences: The Impact of OECD Pillar I and II Proposals on Small Open Economies' (2020) *European Centre for International Political Economy* No 04/2020; he argues that the Two-Pillar Solution will shift taxing powers away from smaller economies to the larger, less economically open governments.

based jurisdiction. Outside of these two scenarios, no other basis for jurisdiction to tax has been recognised.

3.2. Pillar One

First, this thesis will give a brief explanation of the main features of Amount A. Detail on Amount B and the dispute settlement mechanism can be found in Chapter I.

Amount A

Amount A creates a new taxing right for market jurisdictions over a share of MNC groups' residual profits. This taxing right aims to tax in the jurisdiction of the end user by reallocating a share of residual profit where an MNC group earns above a certain amount within a jurisdiction, regardless of whether that MNC has a physical presence within that particular jurisdiction. Thus it moves away from the traditional requirements of residence or permanent establishment.

i. Scope

Originally, the scope of Amount A was differentiated depending on whether an MNC group's activities fell within one of two categories: Automated Digital Services (ADS), and Consumer Facing Businesses (CFB).[136] However, in its July 2021 update, the OECD indicated that such terms have been removed, with a singular threshold decided upon, and all MNC groups which meet that threshold to be considered in scope.[137] Those MNC groups which fall within scope are "Covered Groups" for the purposes of Amount A. The threshold for falling within Amount A is a global turnover above 20 billion euros, coupled with a residual profitability level above 10 percent.[138] Such threshold will drop to a 10 billion euro global turnover upon review seven years after Pillar One has come into force.[139] Revenues and profits related to regulated financial services and extractives are to be excluded.[140] It is worth noting that as of writing, the majority of MNC groups that satisfy this

[136]Pillar One Blueprint (no 30), 2.1.
[137]OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (1 July 2021) ["July 2021 Statement"], 1.
[138]OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 October 2021) ["October 2021 Statement"], 1.
[139]*Ibid*, 1.
[140]*Ibid*, 1.

threshold are head-quartered in the United States.[141] Further, the removal of ADS and CFB categorising from the scope requirements theoretically opens up the application of Amount A to any MNC that meets the threshold requirements, regardless of whether they are a part of the digital economy. Thus the scope of Pillar One has certainly expanded past purely digital goods and services companies, as was originally envisaged.

ii. Nexus, sourcing rules and tax base

The special purpose nexus rule functions to determine which market jurisdictions are eligible to exercise Amount A taxing rights. In order for Amount A to trigger, there must be sufficient market or economic presence of an MNC in a particular jurisdiction. This is proposed by the OECD to be "active and sustained participation of a business in the economy of that jurisdiction through activities in or remotely directed at that jurisdiction".[142] The exact nexus numbers were published in July 2021; a market jurisdiction will be allocated Amount A taxing rights where an MNC within the scope of Amount A earns at least one million euros in revenue from the applicable jurisdiction.[143] In order to ensure that smaller economies also benefit under Amount A, in the case of a jurisdiction with GDP lower than 40 billion euros, the nexus rule is set at 250,000 euros.[144] As of July 2022, detailed revenue sourcing rules have been developed to support the nexus rule; the approach is to begin with the MNC group's total profit or loss in its consolidated financial statements, adjusting to arrived at a standardised Adjusted Profit Before Tax figure, and carrying forward losses.[145] Amount A's tax base is based upon profits of a consolidated MNC group, not profits of a particular, separate entity within the group.

iii. Profit allocation, or the "Quantum"

The amount to be reallocated will be calculated using a formula built on three distinct elements: a profitability threshold, a reallocation percentage, and an allocation key to distribute the tax base among eligible market jurisdiction.[146] Following the October 2021 update, it has

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141 Robert Kiggins, 'OECD Pillars One and Two: A New Paradigm for Income Taxation of International Business?' (2021) *Corporate Taxation* 31, 34.
142 Pillar One Blueprint (no 30), [6].
143 July 2021 Statement (no 137), 1.
144 *Ibid*, 1.
145 OECD *Fact Sheet Amount A: Progress Report on Amount A of Pillar One* (July 2022) [Fact Sheet], 3.
146 Pillar One Blueprint (no 30) [496].

been established that twenty-five percent of residual profit will be reallocated to market jurisdictions with nexus.[147]

iv. Elimination of Double Taxation

Current international corporate taxation rules already expose the entirety of an MNC's global profit to taxation; thus a mechanism is required so as to avoid double taxation once Amount A is implemented. This mechanism is made up of two elements: identification and elimination.[148] Identification refers to finding the entity within the MNC group that will bear the burden of Amount A liability; this is done through a profitability test, with allocation to those entities which have a connection with the market jurisdiction and are able to bear the liability as the priority.[149] The obligation to relieve double taxation is then allocated to the relevant jurisdiction. Elimination of the double taxation burden, on the other hand, is to come either through the exemption method or the credit method.[150] The exemption method involves, as suggested by the name, exemption from taxation on the portion of profits allocated under Amount A, while the credit method makes available tax paid under Amount A as a tax credit.

This chapter will limit its discussion to Amount A, as it is here that the largest change to the principle of jurisdiction tax will unfold. It is the nexus rule of Amount A which is most relevant to the discussion in this chapter. The big change between Amount A and the current structure is that under Amount A there is no requirement for the physical presence of a corporation within the market jurisdiction for that state to have a jurisdiction to tax. Rather, what is required is "active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction".[151] What does this mean in terms of jurisdiction to tax? Does Amount A ground itself in an accepted basis of jurisdiction, or will a market state be exceeding its jurisdiction in attempting to collect taxation under Pillar One?

3.2.1. Hypothetical Example

In order to analyse the interaction between Amount A and the principle of jurisdiction, it is helpful to lay out exactly which taxing

[147]October 2021 Statement (no 138), 2.
[148]Kiggins (no 141), 36.
[149]Pillar One Blueprint (no 30), [557]-[569]
[150]*Ibid*, [570]-[571].
[151]*Ibid*, [6].

rights Amount A will allocate, and to which states. To do so, this paper will introduce a very simple hypothetical scenario, and compare the outcome both under the current taxation system and the envisioned Amount A.

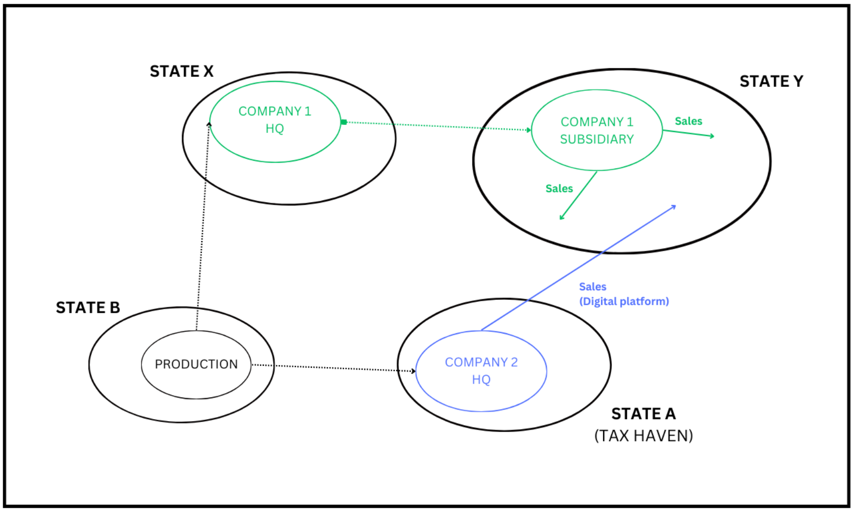

Figure 1: Diagram illustrating two hypothetical MNC structures.

As seen in the diagram above, there are two companies in this set up. Company 1 (C1) is a traditional "brick and mortar" firm which is headquartered in, and therefore a resident of, State X. It produces goods in State B, which it then sells to consumers in State Y, through a subsidiary set up in that state. On the other hand, Company 2 (C2) is headquartered in State A, a tax haven, and employs a "digitalised" method of sale to sell its goods to consumers in State Y. As a result, C2 has no physical presence in State Y.

<u>Current system</u>

Under the corporate income taxation system as it currently exists, taxation of C1's business profits functions as expected. Jurisdiction under the current system is based on two developments from the territoriality principle: residence-based jurisdiction, and source-based jurisdiction. Since C1 is a resident of State X, this state has residence-based jurisdiction, and may therefore impose corporate tax on C1; whether State X is required to offset income imposed by the source country, State Y, will depend on the existence of a double taxation treaty between the two states. State Y holds taxing rights over income arising from business activities carried out on its territory. That jurisdiction to tax arises from the existence of a genuine link between State Y and C1's income. Since C1 is not a resident of State Y, the genuine link is found by tax law in the existence of a permanent establishment (PE) within State Y's territory. Thus, State Y, as the source jurisdiction, is able to exercise its taxing rights over all income attributable to C1's subsidiary.

The case of C2, however, has different results. Residence-based jurisdiction arises as with C1, since State A has jurisdiction to tax C2; the nexus requirement is satisfied by the fact that C2 is a resident in State A. It is in the case of State Y that the shortcomings of the current system begin to show. C2 effects sales to consumers residing in the territory of State Y, and gains profit from these sales. However, it does so through the use of a digital platform, meaning that it has no physical presence, and no need for such presence, in the territory of State Y. This means that for the purposes of international tax law, no PE exists, and thus, State Y's source-based jurisdiction is not triggered. As a result, State Y can exercise no income tax over the profits that C2 makes from selling to State Y's citizens. This is clearly an imbalance in the tax scheme, and is, for many reasons that will not be entered into here, an undesirable outcome.[152]

Under Amount A

How does the situation differ under the proposed Amount A taxing right? This example assumes that both C1 and C2 meet the thresholds for the scoping rule. State X's taxing rights, as the state of resident remain unchanged, since Pillar One focuses upon source taxation. In the case of C1, which has a PE in the market jurisdiction (State Y), it is possible that it may be exempted from Amount A pursuant to a "safe harbour" provision which has been discussed; this would apply where the in-scope revenue of the MNC is below a certain threshold.[153] Such

[152]The majority of academics are clear on the fact that tax base erosion is damaging economically, since it distorts the market, and forms barriers to effective competition and trade. See, for example, OECD, *Addressing Base Erosion and Profit Shifting* (2013).
[153]October 2021 Statement (no 138), 2: "Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe harbour will cap the residual profits allocated to the market jurisdiction through Amount A. Further work on the design of the safe harbour will be undertaken."

safe harbour is intended specifically for those MNCs which have a physical presence in the market jurisdiction, since, as demonstrated above, the market jurisdiction already exercises taxing rights over the relevant income. However, if C1 does not fall under the threshold, then Amount A will apply regardless of the existing PE. This detail is, for now, still under discussion. For the purposes of this chapter's discussion, however, the allocation of a taxing right over C1 in this way is arguably not an issue, since jurisdiction clearly exists on the basis of the source principle.

In regards to C2, the situation is once again different. Firstly, there is a particular threshold of revenue from sales in a jurisdiction that must be met. In order for Amount A to apply, an MNC must earn at least one million euros in revenue from the applicable jurisdiction. In the case of a smaller economy, with a GDP below 40 billion euros, a revenue of 250,000 euros will suffice. Assuming that C2 does so from its sales in State Y, Amount A will operate to give State Y a taxing right over C2's residual profits. Thus, the OECD Pillar One proposal clearly expands a market state's jurisdiction to tax, granting taxing rights in a situation which, as the framework currently stands, would not allow taxation by that state.

3.3. Basis for Jurisdiction?

Existing jurisdiction to tax, even when taxing a foreign corporation as a source state, is based upon the territoriality principle. Can the Amount A taxing right be justified in the same way? Arguably, it cannot. Traditional jurisdiction to tax grounds itself in territoriality through two factors: either the fact of residence of the taxpayer, or the fact of a PE attributable to the taxpayer and present in the taxing state. The common factor between both of these is physical presence. Thus it is clear that, currently, physical presence is considered a requirement for international corporate taxing rights to arise. Amount A, however, explicitly allocates a taxing right where no physical presence is exists. It does so on the basis of sufficient and sustained economic presence. This is a clear departure from the traditional approach, allowing source taxation without any physical presence of the taxpayer in the jurisdiction.

Thus what sufficient link exists between the state and the taxpayer, so as to permit exercise of jurisdiction over them? Perhaps the theoretical principles underlying jurisdiction in international taxation law, both existing and asserted, can be of some aid here.

3.3.1. Economic Allegiance

It is the doctrine of economic allegiance that underpins the existing residence versus source distinction when it comes to jurisdiction to tax. The forms of economic allegiance considered to ground jurisdiction to tax were territorial origin of income, and the country of residence of the taxpayer. Can "sufficient and sustained economic presence" be considered a form of economic allegiance capable of grounding jurisdiction to tax? It is the view of this author that the PE requirement imposed by international tax treaty law is not in itself an inherent requirement of the source basis for jurisdiction. Rather it is considered an "indication for strong and visible 'economic allegiance' to a source jurisdiction".[154] Thus the existence of a PE suggests a strong enough link between taxpayer and state to allow exercise of jurisdiction. As Rocha points out, the PE idea does not reflect an "absolute and universal criterion".[155] This suggests that, if treaty law is amended, there exists no theoretical barrier to a certain level of 'economic presence' itself providing evidence of 'economic allegiance', without physical presence, and therefore a sufficient link between a taxpayer and a state. In fact, Couzin goes so far as to argue that even the concept of residence for the purpose of tax law is simply an indicator of presence within a tax regime; as Wilkie paraphrases, Couzin states that "corporate residence may be less a determinant of the scope of taxation in relation to a person and a particular jurisdiction than a means of identifying a taxable presence more generally".[156] If so, why should economic thresholds not be viewed as simply another way to identify such 'taxable presence'?

How should significant economic presence be measured? At what point does a corporation's participation in a market cross from mere access to economic allegiance to that market state? The OECD has, in its Action One literature, offered a variety of factors that may be of use. These include quantitative benchmarks such as the amount of revenue from a market, the cost spent by a corporation in a particular market,

[154] Wolfgang Schön, 'Ten Questions about Why and How to Tax the Digitalized Economy' (2018) Bull Int'l Tax'n 278, 279.

[155] Sergio Rocha, 'International Fiscal Imperialism and the "Principle" of the Permanent Establishment' (2014) 68:2 Bull Int'l Tax'n 83, 84.

[156] J. Scott Wilkie, 'Locating Corporate Business Income: Reconsidering the Tenets of International Tax Jurisdiction' (2003) 51 Can Tax J 1574, 1584 (discussing Robert Couzin, *Corporate Residence and International Taxation* (IBFD, 2002).

or the number of active users, in the case where a digital platform exists.[157] Suggested qualitative benchmarks, on the other hand, included the existence of a local domain or dedicated local digital platform, or local payment options, among others.[158] It is clear from the more recent Pillar One documentation that the OECD has chosen to use revenue as the relevant threshold in determining nexus for Amount A; as mentioned above, a sufficiently close link is considered to exist where an in-scope MNC earns at least one million euros from a market jurisdiction (250,000 euros in the case of smaller economies).

Does the mere fact that a corporation makes sales in a state's territory justify the existence of a taxing right? In other words, does the fact of a certain amount of profit from a jurisdiction, without physical presence (and the corresponding investment) in that jurisdiction, establish a robust economic link between the taxpayer and state so as to ground jurisdiction to tax? Scholars' views on this question are divided.

<u>The revenue threshold as the nexus</u>

It has been argued by some scholars that volume of revenue is not an appropriate indicator for whether a corporation has 'significant and sustained engagement' with a market jurisdiction, so as to justify a jurisdiction to tax. Samari, for example, asserts that the nexus should be based on functions or cost, not on sales.[159] He argues that a nexus based upon sales cannot take into account the "issues involved in business start-up phases or … the effects of economic cycles"; instead, the emphasis should be on a corporation's marketing activities within the market jurisdiction.[160] Thus Samari's doubt about a revenue threshold seems to be that sales themselves do not necessarily show that a corporation has integrated into a jurisdiction, not in the same way that the existence of a PE does. Similarly, Brokelind feels that Pillar One, by expressing the genuine link in terms of sales figures, "provides for a mere presumption that a large number of people with internet access legitimises taxation at source".[161]

[157] OECD, *Addressing the Tax Challenges of the Digital Economy: OECD/G20 Base Erosion and Profit Shifting Project, Action 1: Final Report* (2015) ["Action 1 Final Report"] [280].
[158] *Ibid*, [279].
[159] Alessandro Samari, 'The OECD Secretariat Proposal for a "Unified Approach" under Pillar One: Strengths and Weaknesses of the New and Revised Nexus and Profit Allocation Rules' (2020) 27 Intl Transfer Pricing J 2, section 2.1.
[160] *Ibid*, section 2.1.
[161] Cecile Brokelind, 'The Power to Tax in International and EU Tax Law: Who is Sitting Behind the Wheel?' in Johan Linhdolm and Anders Hultqvist

However, this line of thinking is too reductive. The revenue that a company derives from a market is not only evidence of sales or existence of consumers, but also acts as an indicator for other factors; specifically, it is "very unlikely that a company can derive a considerable amount of income without making an investment" in that jurisdiction, whether that be for marketing purposes, or to establish and maintain digital platforms for the purpose of engaging with consumers, for example.[162] Thus, significant revenue from a particular jurisdiction can act as an indicator of the corporation's engagement with that jurisdiction, and therefore suggests economic allegiance.

Another criticism that could be put forward is that if a corporation does not have a physical presence within a state, taxation of that corporation is not in line with the benefits theory that underlies international taxation law. It may be argued that, without a PE, corporations do not make use of public goods such as infrastructure, nor public services including the fire brigade or police force. Thus, since these corporations do not derive benefit from the market jurisdiction, there is no justification under the benefits theory to impose taxation upon them.

This is simply not the case. Due to the nature of today's digitalised economy, a corporation does not need to be physically present in a market in order to benefit from government-funded structures. As Gadžo states, the "total amount of revenue that a taxpayer derives from a specific country is probably a good proxy for … public benefits related to the market access therein".[163] A corporation benefits widely from the digital infrastructure of a state, particularly where such corporation has no physical presence and thus relies on digital platforms to access the market of that state. Examples of such benefits are argued to include the enforcement of payment by customers, supply of energy, protection of intellectual property rights, and recycling of waste, by the market state's governmental bodies.[164] To take such an argument even further, one may contend that "the market in any country could not exist without the necessary physical, economic, and legal infrastructure, and this is largely a result of

(eds) *The Power to Tax in Europe* (Hart, 2023) 202.

[162] Erik Lourenco, 'Tax Challenges of the Digital Economy: An Evaluation of the New OECD Nexus Rule Based on Revenue Thresholds (2022) Bull Int'l Tax'n 197, 202.

[163] Gadžo (no 109), 296.

[164] Hongler and Pistone, 'Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy (2015) WU International Taxation Research Paper Series No 2015-15, 22.

governmental functions".[165] By accessing and profiting from such a market, a corporation makes use of public goods provided by the state, and benefit theory therefore justifies taxation of that corporation in return. Thus the revenue threshold approach is "highly desirable from a normative perspective" since it is both neutral and simple, as well as satisfying the benefit theory that underlies taxation on a policy level.[166]

In addition, it should be pointed out that Pillar One's Amount A will not be the first taxation measure to employ a revenue threshold. A significant number of countries have either introduced or proposed unilateral measures taxing the digital economy, and many of these measures do employ a revenue threshold for the purpose of deciding whether a sufficient link, and therefore jurisdiction, exists. Examples of such states include Austria, Belgium, Brazil, Franch, India, Nigeria, Spain, Turkey and the United Kingdom, among others.[167] Lourenco points out that such domestic decisions act as an indication that revenue is considered "a reliable and internationally widespread indicator of a qualified connection between companies and market jurisdictions".[168] Thus, the use of a revenue threshold has not been brought out of nowhere by the OECD, and seems to be accepted by many states as an acceptable indicator of a sufficient link.

3.3.2. Value Creation

In the process of developing the BEPS Action Plan, and the resulting Two-Pillar Solution, a new doctrine has increasingly been mentioned as supporting the allocation of a taxation right based upon sales. This is the principle of "value creation", which has been put forward by the OECD as the theoretical basis for jurisdiction to tax based on a revenue link. It has been used in much of the OECD's literature surrounding the Pillar One proposal; in fact the very purpose of the BEPS project is to "ensure that profits are taxed where economic activities take place and value is created".[169] Yet, the concept itself remains extremely vague. The minimum consensus behind this principle is that taxing rights should be allocated to where value is created; it is a source principle, which, read in the context of OECD proposals, sees interaction with

[165] Fred Brown, 'An Equity Based Multilateral Approach for Sourcing Income Among Nations' (2011) 11:7 *Florida Tax Review* 565, 610.
[166] Gadžo (no 109), 319.
[167] Lourenco (no 162), 202.
[168] *Ibid*, 202.
[169] OECD, *Explanatory Statement: OECD/G20 Base Erosion and Profit Shifting Project* (2015), [1].

consumers in a market as creating "value" and therefore justifying taxation by that market jurisdiction.

Those in support of the concept of value creation argue that it serves to demonstrate the logic behind treating sales as a connecting factor for jurisdiction to tax. Harris discusses the idea of value creation in relation to intangibles; he concludes that, since the value of an intangible is only in those countries where it can be exploited for profit, such value should be seen as created in the country of sales.[170] Cerioni, though he doesn't explicitly mention value creation, argues in a similar direction. He states that, since sales are "the ultimate origin of profit" and without sales there would be no income to tax in the first place, taxation by the market jurisdiction is justified.[171]

The problem with value creation is that, despite the overwhelming amount of literature focusing on the principle, it remains impossibly vague and accommodating.[172] This sentiment forms the basis of most criticism of value creation as it currently stands. Bal points out that no objective definition of value creation exists, nor have any thresholds or factors been developed.[173] Thus, every state is able to interpret the principle as best suits its own local economy, and so argue justification to expand their jurisdiction to tax in essentially any direction. This is the case with Cerioni's assertion above, that sales are the ultimate origin of profit; this argument loses its strength when one considers the fact that without production, for example, there would be no goods to sell and thus no income either. A similar statement can be made with regards to logistics or business decisions and planning by headquarters: without such work, it would be impossible for sales to come about in the first place. Thus, although Cerioni's argument provides a justification for taxing in the market state, it can also justify taxation in the production state or at others stages in the corporate value chain. Further, Quentin points out that the same set of facts can be interpreted in several different directions, yet remain consistent with the value creation principle throughout.[174] To demonstrate this, he gives the example of a tax dispute involving Amazon's tax structure. This

[170]Harris (no 18), 104.
[171]Luca Cerioni, 'The New "Google Tax": The "Beginning of the End" for Tax Residence as a Connecting Factor for Tax Jurisdiction?' (2015) 4.
[172]Christians (no 14), 40.
[173]Aleksandra Bal, '(Mis)Guided by the Value Creation Principle – Can New Concepts Solve Old Problems?' (2018) 72 Bull Intl Taxn 11, 13.
[174]David Quentin, 'Corporate Tax Reform m and Value Creation: Towards Unfettered Diagonal Re-allocation Across the Global Inequality Chain' (2017) 7 Account Econ Law 1, 6-13.

example makes a very relevant point about the weakness of value creation when attempting to use it support Amount A, and is therefore worth discussing in some detail here.

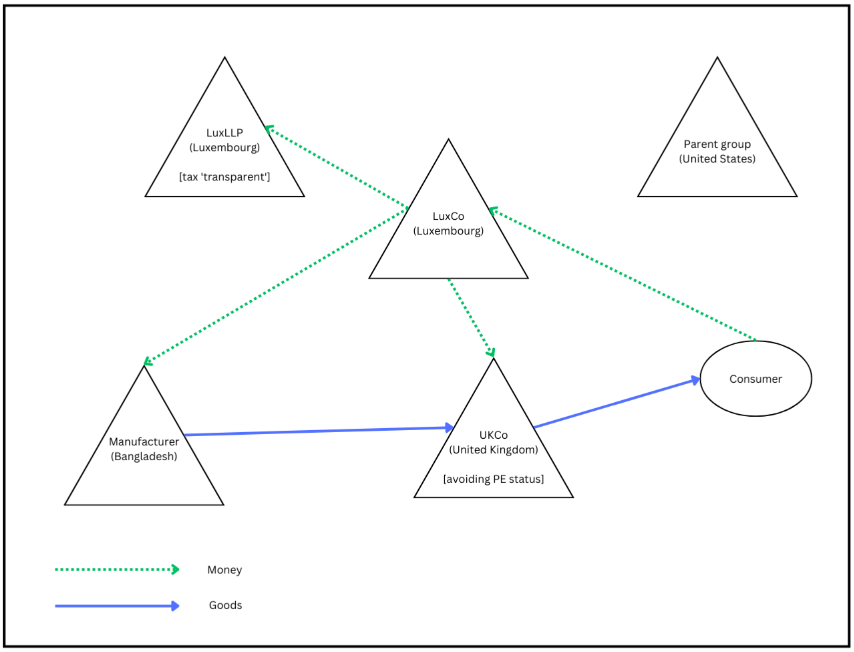

Figure 2: Diagram depicting tax structure discussed below.

Re-created from David Quention, 'Corporate Tax Reform and "Value Creation": Towards Unfettered Diagonal Re-allocation Across the Global Inequality Chain' (2017) 7 Account Econ Law 1, 10.

Quentin lays out a simplified 'value chain' representing that of Amazon: a company manufacturing clothes in one state sells such product to the internet retailer in another state, who then sells these clothes on over the internet at a profit. Here, Amazon's tax structure becomes relevant. It was set up in such a way that one entity, incorporated in Luxembourg (LuxCo), ran the internet retail platform, and a second entity, incorporated in the UK (UKCo), operated fulfilment centres and provided logistics services to LuxCo.[175] A separation of functions, wholly contractual and not reflecting commercial reality, was set up by the company, so that LuxCo was engaged in the business of selling

[175]Quentin (no 174), 7-8.

clothes to UK customers, and UKCo was a service provider to LuxCo.[176] The aim of such arrangement was to have the company's profits arising in Luxembourg, rather than in the UK. From there, LuxCo paid a royalty to a limited liability partnership resident in Luxembourg (LuxLLP), which is also within the Amazon group structure. Since Amazon had obtained a favourable ruling from Luxembourg in relation to pricing of this royalty, only a small residual profit was taxable in Luxembourg.

The reason this example is relevant to the current discussion of value creation is because several interventions were made against Amazon, by different bodies with different interests, yet every intervention was "consistent with a narrative whereby the tax outcome is intended to align with where value creation … is situated".[177] Firstly, the UK enacted a "diverted profits tax", which imposed a punitive rate of twenty-five percent to situations where a corporation makes substantial sales in the UK whilst avoiding the creation of a UK PE or whilst using foreign entities to minimise tax liability.[178] This intervention is consistent with an interpretative of value creation which argues that the logistics activities carried out by UKCo substantively create value, which is only realised in LuxCo on a computational basis.[179]

Next, the European Commission brought proceedings against Luxembourg, arguing that the favourable tax rulings Luxembourg had made on behalf of a number of MNCs, including Amazon, constituted illegal state aid. Such argument, although it aims to allocate taxing rights to the residence country rather than the UK and thus is in conflict with the UK's position, is, Quentin argues, still consistent with the principle of value creation. This is because value can be interpreted as being created by both LuxCo and UKCo, and that value is entirely out of proportion with the residual profit left in LuxCo post payment of the royalty to LuxLLP. Finally the US Internal Revenue Service also had concerns, in regards to the intellectual property initially transferred into LuxLLP, for which LuxCo was paying its royalties. The US contended that the royalty was under-priced, according to the arm's length principle. This position can, once again, be seen as in line with value creation: value creation took place in the US when the intellectual property was produced, and such value exceeded what was received in return for transfer of the intellectual property. Thus it is clear from this example that value creation can be used to argue various narratives, to

[176] Quentin (no 174), 8.
[177] *Ibid*, 12.
[178] Cerioni (no 171), 1-2.
[179] Quentin (no 174), 9-10.

an extent that it effectively becomes useless as support for sales-based jurisdiction to tax. After all, with so vague a concept and no delineating factors, "almost any location can be considered as having contributed to value creation in some way".

Another interesting line of criticism is that made by Nikolakakis, who argues that value creation as a theory does not support taxation based on sales revenue at all; he insists that to see it so is to confuse "value creation" with "value exchange".[180] In his view, a sale does not create value but rather is a "transaction in which parties exchange values", with such values having been created prior to the exchange.[181] Thus, there is no creation of value in the market state at all, and taxation should focus on other aspects of the corporation's value chain.

What is clear from the criticisms of the value creation concept is that it cannot satisfactorily be relied on for justification of a taxing right based on sales in a market jurisdiction. It is simply too vague, and too open to any interpretation that a self-interested party may try impose on it. Thus value creation cannot be considered a principle with legal force. This should not, however, be considered to be fatal to the legitimacy of a sales-based nexus for taxation.

3.3.3. Other Theoretical Support for Sales-Based Jurisdiction?

Even without the value creation principle as underlying theoretical support, the idea of sales as a connecting link for tax jurisdiction already has considerable influence, in the form of those arguing for a destination-based corporate tax (DBCT).[182] The DBCT, as envisioned by its supporters, would entirely replace the current corporate income tax model, replacing source- and residence-based jurisdiction to tax with a right to tax arising upon location of the final customer.[183] Although Pillar One's Amount A is not, as such, a destination-based tax, it has a similar effect in that it creates a taxing right where consumers are based. Thus, the theoretical arguments put forward in

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[180] Angelo Nikolakakis, 'Aligning the Location of Taxation with the Location of Value Creation: Are We There Yet?!?' (2021) Bull Int'l Tax'n 549, 559.
[181] *Ibid*, 559.
[182] Cerioni (no 171), 3.
[183] Eva Escribano, *Jurisdiction to Tax Corporate Income Pursuant to the Presumptive Benefit Principle: A Critical Analysis of Structural Paradigms Underlying Corporate Income Taxation and Proposals for Reform* (Kluwer, 2019), 227.

support of legitimacy of jurisdiction to tax in regards to a DBCT also largely apply to Amount A.

Cerioni, in the context of a destination based tax, provides two reasons that justify the market state exercising jurisdiction to tax. Firstly, entitlement to tax is in alignment with the territoriality principle since the market jurisdiction is the location in which activities giving rise to income are being carried out. Deveruex and de la Feria emphasise this point, arguing that sales in a market jurisdiction serve to make that jurisdiction the origin of income.[184] Secondly, the market state, as the location of costumers, provides services which allow such costumers to consume products and services. Thus, the market state provides services which contribute in an indirect manner to the generation of income, and following benefits theory, is therefore justified in taxing that income. This thesis' support for such argument has been discussed in more detail earlier in this chapter.

3.4. Precedence for this Expansion?

Arguments that Pillar One expands jurisdiction to tax in an unprecedented manner may be countered by pointing out that many states have enacted unilateral Digital Services Taxes (DSTs) which allow taxing of income without the need for a physical presence in the state. As of February 2021, there were at least thirty DSTs or equivalent measures in place globally; thus states appear to be in agreement that revenue can form a satisfactory nexus.[185] The Indian DST, for example, applies to revenue from digital services provided to an Indian resident, to a non-resident in certain circumstances, and to a person who buys digital goods and services using an Indian IP address.[186] Thus no physical presence is needed in order for the DST to apply to a corporation, and the connecting link is instead revenue arising from transactions with Indian consumers. Of course the fact that such unilateral measures use sales revenue as a genuine link certainly does not mean that this principle has crystallised into customary law, but what it does suggest is that there is some level of consensus between states and possible movement towards recognising sales revenue as a

[184]Michael Devereux and Rita de la Feria, 'Designing and Implementing a Destination-Based Corporate Tax' (2014) Oxford University Centre for Business Taxation Working Paper 14/07, 12-13.
[185]Robert Goulder, 'The BEPS Gambit: Will the OECD Know When to Resign?' (2021) TNTI 21.
[186]David Spencer, 'An Update on Digital Services Taxes' (2021) *Journal of International Taxation* 35, 41-2.

sufficient basis for jurisdiction. Implementation of Pillar One, as a multilateral measure, would be a significant step in that direction.

It should also be pointed out that the United States has long made use of sales-based revenue thresholds as a factor for assigning taxing rights between federal states. Hellerstein uses such history as a sign that the market has been considered a legitimate basis for grounding taxing rights.[187] Similarly, Avi-Yonah asserts that, since the US has used federal state sales-based thresholds since the 1930s, "the current revolution in international taxation … is less revolutionary than some have argued."[188] The European Union's Common Consolidated Corporate Tax Base also seems to reflect a similar view that sales can be used as a factor in giving rise to jurisdiction to tax. Hellerstein does warn, however, that taxation should not rely too excessively on the market, since the location of capital and labour is also a very significant factor.[189] Although this is a legitimate concern and Amount A only expands jurisdiction to tax for market states, it is an overlay to the existing tax framework and thus does not focus taxing rights too strongly in a particular direction so as to unbalance the entire system.

Finally, Brokelind notes how many transaction taxes offer an even weaker link between state and taxpayer, giving taxes on advertising, gambling and telecommunications as examples. She points out how the Court of Justice of the European Union (CJEU) has yet to rule on the issue of a weak nexus, despite having been offered multiple opportunities to date. For example, AG Kokott in the *Google Ireland* case acknowledged a right of Member States to levy a tax on advertising regardless of where both the service provider and target were located.[190] The Court did not affirm the statement, but it also did not take the opportunity to challenge such a position. However, such magnanimity should not be taken as support of a weakened nexus rule. After all, as AG Hogan pointed out, the questions of competence to tax and adherence to common principles of international law are not within the scope of the CJEU's competence.[191] Thus the Court has avoided ruling on the question of whether a nexus is too weak to ground jurisdiction, and such avoidance should not be misinterpreted as

[187] Walter Hellerstein, 'A US Subnational Perspective on the "Logic" of Taxing Income on a "Market" Basis' (2018) Bull Int'l Tax'n 293, 294-295.
[188] Reuven Avi-Yonah, 'The International Tax Regime at 100: Reflections on the OECD's BEPS Project' (2021) Bull Int'l Tax'n 522, 526.
[189] Hellerstein (no 187), 295.
[190] Case C-482/183 *Google Ireland* (CJEU) Opinion of AG Kokott delivered on 12 September 2019, EU:C:2019:728, [48]-[55].
[191] Brokelind (no 161), 198.

support for one position or another.[192]

What these three different examples do prove is that Amount A's nexus requirement is not as unprecedented as it may seem at first read. Of course, it still amounts to a significant change in, and expansion of, international tax law's approach to jurisdiction to tax, particularly in the move away from a physical presence requirement. Yet, the existence of other measures making use of sales revenue-based jurisdictional thresholds provides evidence that states are ready to consider economic presence as nexus, and international experience with such measures can provide information on how Amount A may affect global business.

3.5. Treaty Override of Existing Principles

It is clear that Amount A extends a market state's source-based jurisdiction to tax past that which is currently accepted in international tax law. It does so by disposing of the physical presence requirement embodied by the PE requirement, and instead finding a connecting factor in the form of sales-based revenue. It has been argued that to do so conflicts with the principle of jurisdiction as it currently exists in PIL. And yet, is that not exactly the point of Pillar One?

The past decades have demonstrated beyond doubt to the international community that the current system for allocation of taxation rights cannot effectively encompass the digital economy, or the widespread business structure of MNCs. Thus, jurisdiction to tax as it presently exists is not fit for purpose. This is the very problem that the Two Pillar Solution has been proposed to fix, albeit that the nature of tax law is such that the centrality of jurisdiction to the issue is often overlooked. To rephrase, jurisdiction to tax under international tax law has become too narrow, leading to situations where logic calls for tax to be exercised but the law cannot follow. Some expansion of jurisdiction is necessary. Such expansion, in the case of Pillar One, is to be achieved through the use of a multilateral instrument; this creates new treaty law, which will supersede the existing customary international law in this specific area. Consequently, it can be argued that once Pillar One is implemented through the MLC, there can be no conflict with the previous jurisdiction to tax principle. In passing a multilateral treaty, the states have agreed that a revenue threshold, without physical presence,

[192] Cases where the CJEU has avoided the question of state competence to tax include Case C-48/15 *NN (L) International* (2016) EU:C:2016:356, and Case C-725/19 *Anton van Zantbeek VOF* (2020) EU:C:2020:54.

constitutes a legal basis for jurisdiction to tax.

To take this view, however, is not to render obsolete the earlier discussion of this chapter. Jurisdiction to tax, even if expanded past the physical presence requirement as Amount A intends, remains a principle built upon the theory of economic allegiance. Not only this, jurisdiction to tax remains bound by general principles of jurisdiction in PIL. It is clear that, no matter how broken the current system, this does not provide states with unlimited license to expand jurisdiction to tax as far as they possibly can. The *Lotus* case, though old and oft criticised, remains authority for the fact that states do not have unlimited extra-territorial jurisdiction. Rather, changes to jurisdiction to tax must still be legitimate from the point of view of PIL, and such legitimacy comes from sound backing from existing, accepted theories of jurisdiction. As this chapter has attempted to prove, Amount A remains within the borders of the theory of economic allegiance, and therefore Pillar One does not constitute an unjustified grab at increased taxation revenue.

3.6. Conclusion

This chapter has addressed several issues relating to jurisdiction that are brought forward by Amount A.

Firstly, Amount A allows a state to exercise jurisdiction to tax on an extra-territorial basis, without any requirement of physical presence. This raises the question of whether such jurisdiction to tax extra-territorially contravenes the general principles of international law as laid out in Chapter II. However, as this thesis has attempted to demonstrate, Amount A is reconcilable with the nexus requirement in international law. This is because significant economic presence, demonstrated by a certain level of revenue within a market, constitutes a sufficient link between the state and the taxpayer. Thus jurisdiction arises on this basis.

Issues in relation to sales revenue-based jurisdictional thresholds have also been raised, with some scholars concerned that revenue is not an appropriate basis for signaling significant economic presence within a jurisdiction. However, when one considers that a substantial amount of revenue cannot be generated from a jurisdiction without significant engagement on the part of the corporation, either through marketing or other forms of investment, such concerns lose their weight. Revenue is able to act as an indicator for economic presence since it suggests integration into a jurisdiction, beyond simple access.

Finally, it has also been pointed out by this chapter that Amount A will not be the first tax measure to ground jurisdiction to tax on revenue thresholds, nor to allow taxation without physical presence. Measures currently in place, such as Digital Services Taxes or taxes on advertising, already do so. Thus although Amount A appears to expand jurisdiction to tax in an unprecedented manner, when considered in context it is not so dramatic as first appears. It does expand jurisdiction to tax, but it does not do so in a manner which exceeds theoretical support for such jurisdiction.

Further, the current reality of taxation has proven that the way in which jurisdiction is currently allocated is not working. Change is needed, and such change will necessary push the boundaries of the existing principle of jurisdiction. As long as any such expansion is supported by theory, it should be approached with an open mind.

Chapter 4. Pillar Two and the Close Connection Doctrine

4.1. Introduction

Current international academic focus has mainly turned from Pillar I to Pillar II, since the latter is beginning to seem more achievable than the former. This is in large part due to the complexity of Pillar One, and the requirement for consensus.

Progress on Pillar Two has been somewhat steady. The rules are intended to be implemented by domestic law, without need for a multi-national instrument; this is in contrast to Pillar One, which is intended to be implemented by the Multilateral Convention. Many states have therefore already begun to draft, or implement, domestic legislation. The United Kingdom, for example, published draft legislation for the implementation of Pillar Two tax rules in July 2022; the Spring Finance Bill 2023, implementing the IIR and UTPR, and a domestic top up tax, followed on 23 March 2023.[193]

However, Pillar II brings up several significant issues with regards to jurisdiction. It has even been accused of highlighting a certain "casual disregard for international law" among taxation lawyers.[194] A significant part of the debate about Pillar II has therefore revolved around the question of whether a sufficient link exists between the income taxed by Pillar II's income inclusion rule (IIR) and under-taxed profits rule (UTPR). Supporters of Pillar II have contended that the GloBe rules can be compared to the existing Controlled Foreign Corporation rules, which have been recognised as jurisdictionally legitimate by the international community.[195] It has also been argued that the UTPR itself is not an income tax, at least not in the form recognised by the current system, and thus the nexus requirement rule does not apply at all.[196]

[193]Finance (No. 2) Bill, Government Bill, Originated in the House of Commons, Session of 2022-23; for Pillar Two related legislation, see Part Three (Multinational Top-Up Tax) of the Bill, and for the corresponding domestic top up tax, see Part Four (Domestic Top-Up Tax).
[194]Brauner, (no 41) 268.
[195]See Christians (no 14).
[196]See Allison Christians and Stephen Shay, 'The Consistency of Pillar 2 UTPR with US Bilateral Tax Treaties' (2023) 109 Tax Notes Int'l 445.

Yet critics are just as passionate in their dissent, putting forward several threads of argument as to why the GloBe rules are concerning from the perspective of PIL: the major criticism here is that Pillar Two allows states to tax income to which they have no connection at all, in contravention of the principle of jurisdiction.

4.2. Pillar Two

Pillar Two consists of four rules: the income inclusion rule (IIR), the under-taxed payments rule (UTPR), the switch-over rule, and the subject to tax rule.

Income Inclusion Rule

The Income Inclusion Rule creates a minimum tax. It does so by requiring the foreign parent company or foreign shareholders of a corporation to include that corporations' income within their own earnings, where such corporation's subsidiary in a different state is subject to an effective tax rate less than fifteen percent.[197] Thus it essentially transfers taxing rights to the residence state of shareholders, where the source state has elected not to apply a fifteen percent rate of tax. As Silva points out, the IIR seems to be envisaged as the primary rule, such that the Under-taxed Payments Rule will only come into play where payment is made to a corporation not subject to the income inclusion regime.[198]

Under-taxed Payments Rule

The Under-taxed Payments Rule will apply where a subsidiary makes a cross-border payment to a subsidiary within the same parent group, or transfers profits. In such a case, a third state in which a subsidiary of the same parent company operates may deny a tax deduction on these payments.[199] This is possible where the effective tax rate of the

[197] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)* (OECD, 2021) ["Pillar Two Model Rules"], Article 2.1.1.: "A Constituent Entity, that is the Ultimate Parent Entity of an MNE Group, located in [insert name of implementing-jurisdiction] that owns (directly or indirectly) an Ownership Interest in a Low-Taxed Constituent Entity at any time during the Fiscal Year shall pay a tax in an amount equal to its Allocable Share of the Top-Up Tax of that Low-Taxed Constituent Entity for the Fiscal Year."
[198] da Silva, (no 39) 127.
[199] Pillar Two Model Rules (no 197), Article 2.4.1.: "Constituent Entities of an MNE Group located in [insert name of implementing-Jurisdiction] shall be

subsidiary making the payment is less than the required fifteen percent. In such case, the state in which the receiving subsidiary is located is effectively imposing additional tax upon the subsidiary in its jurisdiction, as the 'related' subsidiary is considered under-taxed. The UTPR aims to target cross-border payments used for the shifting of profits between subsidiaries. Examples of payments typically used for such purpose include deductible interests or royalties for intra-group payments.[200]

In the OECD's earlier related literature, the UTPR was referred to as the 'Undertaxed Payments Rule'. However, in academic literature, it is now referred to as the Undertaxed Profits Rule; this change in terminology reflects an expansion of the scope of the UTPR from payments to profits in the model rules.[201] The model rules do not themselves explain the acronym UTPR, simply defining it as "the rules set out in Article 2.4 to Article 2.6", nor do they specifically refer to payments or profits.[202] This unspoken switch from payments to profits changes the nature of the UTPR, leading it to effectively create a new grounds for jurisdiction to tax rather than simply preventing base-eroding payments.[203] Some academics disagree with such statement, stating that the idea behind the UTPR has remained "constant", but this paper notes the change as an important expansion of the UTPR's scope.[204] However, since OECD literature continues to refer to the UTPR as the 'Undertaxed Payments Rule', this paper has followed suit.[205]

The switch-over rule

The switch-over rule complements the IIR by ensuring that the IIR applies equally to foreign branches as to foreign controlled subsidiaries. This will therefore apply only to those states which adopted the exemption method for the purpose of eliminating double

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denied a deduction (or required to make an equivalent adjustment under domestic law) in an amount resulting in those Constituent Entities having an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction."

[200]da Silva, (no 39) 117.

[201]Pillar Two Model Rules (no 197), articles 2.4, 2.5 and 2.6; for academic discussion see, for example, Christians (no 14) 20.

[202]*Ibid*, article 10.1.1.

[203]Jinyan Li, 'The Pillar 2 Undertaxed Payments Rule Departs From International Consensus and Tax Treaties' (2022) 174 Tax Notes Int'l 1695, 1696.

[204]Allison Christians and Tarcísio Magalhães, 'Undertaxed Profits and the Use-It-or-Lose-It Principle' (2022) 108 Tax Notes Int'l 705, 706.

[205]See, for example, October 2021 Statement (no 138), 3.

taxation, rather than the credit method.

The subject to tax rule

The final element of the GloBE proposal is the subject to tax rule, which requires that treaty benefits are not granted in the source jurisdiction for income that is not subject to the minimum tax rate; it permits source jurisdictions to impose tax up to a globally agreed nine percent minimum rate.[206] This rule is to be implemented by treaty.[207]

Two particular aspects of Pillar II will be discussed in this Chapter: the income inclusion rule (IIR) and the under-taxed payments rule (UTPR).

4.2.1. Hypothetical Example

To effectively discuss the changes in jurisdiction that Pillar II will enact, it is helpful to first consider how the IIR and UTPR will apply in practice. This section will therefore set out a simplified hypothetical example, before discussing how applicable taxing rights will differ depending on whether the Globe rules are applied or not.

[206] October 2021 Statement (no 138), 5.
[207] OECD, *Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (11 July 2023), [14]-[15].

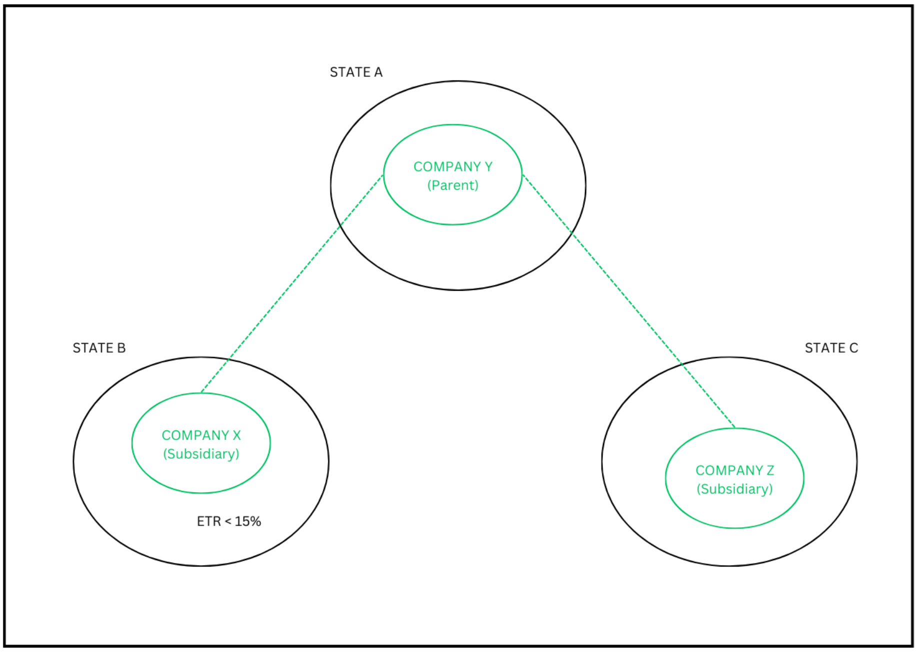

Figure 3: Diagram depicting a hypothetical MNC structure.

Company Y is resident in State A, and has two subsidiaries, Company X in State B, and Company Z in State C. State B does not levy a high corporate tax, with the effective taxation rate on Company X falling below 15 percent.

Scenario One: State A has implemented GloBe rules

Since the effective tax rate on Company X is below fifteen percent, the IIR will apply to allocate taxing rights to State A. Company Y, as the ultimate parent company of Company X, can therefore be required to include Company X's income within its own income; this allows State A to exercise taxing rights over the income of Company X, and thus "top up" the effective tax rate. Since State A is exercising its rights under the IIR, the question of State C utilising the UTPR does not arise.

Scenario Two: State A has not implemented GloBe rules, but State C has

In this case, once again, Company X is subject to an effective tax rate of fifteen percent and thus the GloBe rules activate. However, since State A has not implemented Pillar Two (or chooses not to exercise the IIR), the UTPR comes into play. This means that State C is able to deny tax deductions on cross-border payments made between Company X and Company Z, since such payments are considered to be "under-taxed" by State B. In this way, the lower taxation rate imposed by State B is considered to be offset, such that MNCs are not incentivised to transfer their profits to State B for the purpose of base erosion.

4.3. The Income Inclusion Rule and Undertaxed Payments Rule

In essence, the IIR allows the residence state of a parent company to tax foreign income of a foreign subsidiary. Under current principles of jurisdiction to tax, this would not be possible. The residence state is taxing a foreign company, which does not fulfill the conditions of residence-based taxation jurisdiction. Nor does the foreign subsidiary have a physical presence (PE) in the residence state, and therefore source-based taxation jurisdiction does not arise. It would seem clear, therefore, that the IIR violates the nexus requirement as it currently stands. Yet, there are those who argue in support of the IIR; the strongest argument put forwards by this group is an analogy with the existing controlled foreign corporation (CFC) rules.[208]

These rules are also brought up in support of the UTPR, and thus are best dealt with in the context of both rules.[209] It is the UTPR that has attracted the majority of criticism in relation to the principle of jurisdiction. While many critics of Pillar Two may accept the IIR as valid, they struggle to do the same for the UTPR.[210] As a rule, the UTPR appears to allow a state to impose tax (through the denial of tax deductions) upon income entirely unconnected with that state. The entity which ends up bearing the increased tax burden, the subsidiary in the taxing state, has no shareholding in the low-taxed subsidiary, and thus no connection to income arising from the low-taxed subsidiary's actions in the tax haven.

[208] See, for example, Christians (no 14).
[209] See, for example, Reuven Avi-Yonah, 'The UTPR and the Treaties' (2023) 109 Tax Notes Int'l 45.
[210] Reuven Avi-Yonah, 'UTPR's Dynamic Connection to Customary International Tax Law' (2022) 108 Tax Notes Int'l 951: "Clearly, the income inclusion rule is consistent with CITL, because nobody (including Vanderwolk [one of the UTPR's main critics]) would argue [otherwise]".

Controlled foreign corporation rules

Controlled foreign corporation tax imposes taxation upon a domestic corporation, for the profits of foreign corporation in which that domestic corporation holds a controlling share.[211] Such legislation continues to be controversial.[212] Strictly speaking, there is no link between the taxing state and the income subject to taxation. The foreign corporation is not a resident of the taxing state, so residence-based jurisdiction cannot arise. The foreign company does not operate a PE in the taxing state, nor do the profits made arise from business occurring in the taxing state, so source-based jurisdiction cannot be said to exist. At the time, states claimed to find a connection between the domestic shareholders, and the foreign income in the form of a "deemed dividend" paid from the foreign corporation to the domestic shareholders.

The analogy made by supporters of the IIR, such as Christians, is that both the IIR and CFC rules assign tax among members of commonly controlled groups, rather than treating each member as a strict individual.[213] Thus, in the case of both rules, the income that is the subject of the tax is not directly linked to the domestic taxpayer. It is contended that, since states accept the CFC rules as valid, and not in excess of jurisdiction, the IIR should also be acceptable.[214] Some scholars have attempted to differentiate between the IIR and CFC rules: Schoueri and Galendi argue that CFC regimes are justified on the basis of anti-abuse, and that such justifications do not exist in the context of the IIR.[215] Following such logic, the "look-through" quality of CFC rules is warranted because they function to look through abusive arrangements, whereas the IIR does not qualify for such treatment as it is simply intended to prevent base erosion and does not deal with questions of corporate structuring. However, such argument fails to point out any express legal basis for the assertion that such a distinction exists, or even that anti-abuse considerations affect whether

[211]For more detailed discussion, see Chapter II, p37 onward.

[212]Brauner (no 41), 269, "many, including this author, have serious issues with the questionable acceptance of CFC rules as being compatible with tax treaties".

[213]Christians (no 14), 18.

[214]*Ibid*, 18-20.

[215]Pedro Guilherme, Lindeberg Schoueri and Ricardo Andre Galendi Junior, 'Who is the "Taxpayer" for the IIR and Why Does It Matter?' (*Kluwer International Tax Blog*, 16 Aug 2022) <https://kluwertaxblog.com/2022/08/16/who-is-the-taxpayer-for-the-iir-and-why-it-does-matter/> accessed on 29 June 2023.

a tax rule may treat entities separately or as a group.[216] This thesis holds that the IIR, though it does expand jurisdiction, does so in a direction which has already been clearly accepted by the majority of the international community. The similarities between the CFC regimes and the IIR are potent enough that the IIR's approach to the relationship between a parent company and subsidiary cannot be said to be unprecedented, and thus the IIR does not come into conflict with norms of international law.

The case of the UTPR, however, is more complicated. Unlike the IIR, there is no parent-subsidiary relationship being taken into account. Rather, the only relationship that exists between the two subsidiaries is the indirect fact of shared ownership, at some point in the chain. As Brauner points out, the UTPR is not comparable to the CFC rules; there is no connection between the state imposing the UTPR and the state in which the income arises.[217] The UTPR allocates tax to a body without share-holding in the under-taxed subsidiary, without any connection to the realisation of income in that jurisdiction.[218] To further distinguish, the CFC rules apply where the taxpayer receives clear economic benefit, directly or indirectly, from the income subject to tax; the UTPR does not premise itself on the existence of any economic benefit at all.[219] Avi-Yonah has attempted to defend the UTPR on the grounds that it is a global agreement, and that such agreement grants legitimacy to the extraterritorial application of the tax.[220] The issue with this argument is that in order to overrule, or create an exception to, general principles of international law, a specific and explicit agreement to that effect is required. In other words, if the intention of the participating states is to create an exception to the general doctrine of jurisdiction, this must be done by treaty, as Brauner points out.[221] Pillar Two is not intended to be implemented by a treaty, and thus this line of

[216] Christians (no 14), 19-20.
[217] Brauner (no 41), 269.
[218] Filip Debelva and Luc De Broe, 'Pillar 2: An Analysis of the IIR and UTPR from an International Customary Law, Tax Treaty Law and European Union Law Perspective' (2022) 50:12 *Intertax* 1.
[219] Jefferson Vanderwolk, 'The UTPR, Treaties, and CFC Rules: A Reply to Avi-Yonah and Schler' (2023) 109:2 Tax Notes Int'l 187.
[220] Avi-Yonah (no 209), 45; Magalhães puts forward a similar argument, to the effect that the UTPR should be regarding as constituting a valid exception to the nexus requirement, see Tarcísio Magalhães, 'UTPR Opposition: A Game of Whack-A-Mole' (2022) 108:12 Tax Notes Int'l 1531, 1532.
[221] Brauner (no 41), 269, 271; Vanderwolk echoes this sentiment in Jefferson Vanderwolk, 'The UTPR: Taxing Rights Gone Wild' (2022) 108:11 Tax Notes Int'l 1369, 1370.

argument by Avi-Yonah loses its defensive force.

Another attempt to find an economic connection between the UTPR jurisdiction and the income to which it is applied was put forward by Kadet.[222] He states that such a connection indirectly "arises from the clear pervasiveness of centrally managed groups that have consciously managed their allocations of group profit, all of which use separate-entity accounting, through voluntarily created corporate structuring and intercompany agreements".[223] In essence, his argument is that MNC groups intentionally distribute profits among their subsidiaries, so as to create a particular tax outcome; in doing so, there is effectively an indirect connection between all income of the MNC group and each of the entities within the group. Such connection, Kadet argues, is capable of forming an economic nexus. Yet, to accept such an indirect, vague connection as a sufficient nexus is not a desirable approach. Doing so would effectively widen the scope of the nexus requirement to the point where any indirect link is sufficient to satisfy it. In such a case, the nexus requirement essentially becomes redundant, as any exercise of jurisdiction can be justified. This is clearly an unacceptable position to hold, and Kadet's proposed economic connection is simply too vague.

Some of the main supporters of the UTPR's legitimacy are Christians and Shay.[224] Firstly, they argue that the UTPR imposes tax on local permanent establishments, and thus source-based jurisdiction arises; where the subsidiary being taxed is a resident, jurisdiction is residence-based.[225] However, this line of argument is unconvincing, since the UTPR is taxing income that would not otherwise be attributed to that permanent establishment. It is taxing income considered extra-territorial, and thus in order for jurisdiction to arise over such an income, a genuine nexus is required. In the case of the residence-based jurisdiction argument, such assertion effectively amounts to the idea that a state may "tax business profits of a resident of [another] state who has no PE in the country by simply imposing the tax on a resident of the taxing company"; this is clearly in contravention of the entire existing jurisdiction to tax structure.[226] If such action were

[222]Jeffery Kadet, 'Defending the UTPR: Creative Corporate Structuring Can't Hide Real Connections' (2022) 108 Tax Notes Int'l 1071, 1071.
[223]*Ibid*, 1071.
[224]Christians (no 14); Allison Christians and Stephen Shay, 'The Consistency of Pillar 2 UTPR with US Bilateral Tax Treaties' (2023) 109 Tax Notes Int'l 445.
[225]Christians (no 224), 447.
[226]Vanderwolk (no 219), 187.

legitimate, residence-based jurisdiction would essentially be all encompassing, and the nexus requirement has made it clear that this is not the case. Secondly, they put forward the assertion that the UTPR is not an income tax and therefore not subject to tax treaties; the basis of this argument is that "the UTPR's relationship to the income of a low-taxed constituent entity that gives rise to the top-up tax consists solely of its affiliation through the MNE group".[227] As Brauner rather cleverly points out, this argument simply serves to articulate the manner in which the UTPR violates the genuine nexus requirement.[228] If one can argue that the UTPR is not in substance an income tax, since there is no link between the taxing state and the income giving rise to the tax, then it clearly cannot satisfy the genuine link requirement and is not a legitimate exercise of taxing jurisdiction. If this is the case, and it is instead intended as an anti-abuse measure, the OECD and states involved should state so explicitly, rather than relying on the corporate income tax structure to legitimise the UTPR.

It is clear from the preceding discussion that the proposed UTPR is problematic, from the point of view of jurisdiction. It does not satisfy the genuine link requirement, and as such constitutes an illegitimate expansion of states' jurisdiction to tax. This paper holds that, if it is the intention of the OECD and participating states to expand jurisdiction under the UTPR, they should do so through an explicit agreement to that effect. Such agreement, likely a treaty, would then independently lend legitimacy to exercise of jurisdiction pursuant to the UTPR. Otherwise, it remains in conflict with the existing doctrine of jurisdiction in taxation law.

4.4. Separate Entity Approach versus Group Approach

Both elements of Pillar Two discussed above raise questions in relation to the separate entity approach versus the group approach. Considering that this is a fundamental issue of international taxation law, it cannot possibly be covered adequately in the course of this thesis. However, it is necessary to give a brief outline, for context.

The separate entity approach entails treating each entity within a corporate structure as an individual person for the purpose of taxation.[229] Thus, a subsidiary is taxed upon attributed income

[227] Christians (no 224), 447.
[228] Brauner (no 41), 270.
[229] Harris (no 18), 166: "Even if a corporate group is considered to conduct a single business, each member of the corporate group (each corporation) is

independently of its parent company; in the current system, the PE serves as a mechanism for determining which income is to be allocated to the subsidiary. As a consequence, intra-group transactions will result in taxable income, losses and profits cannot be consolidated, and transfers of profits to shareholders are taxable. No matter whether two corporations are affiliated or commonly controlled, taxes paid by one corporation in one jurisdiction will not constitute taxes paid by a second corporation in a second jurisdiction. The alternative to such an approach is the group approach or consolidation, which treats a group of affiliated companies as one body, with consolidated profits and losses.[230] It is also referred to as unitary taxation.[231] The identity of any subsidiaries effectively collapses back into that of the parent company, which shoulders the overall tax burden.

Taxation law has traditionally dealt with tension between these two approaches; in the domestic context, some states require consolidated tax accounts (group approach), yet international taxation law has traditionally applied the separate entity approach.[232] The OECD has argued that the separate entity approach is the best method for maintaining equitable taxation, and adopted it in its instruments.[233] As a result, international corporate income tax approaches each entity within an MNC group as an individual corporation.[234] Separate taxation of entities therefore forms one of the central pillars of the system of allocation of taxing rights.[235] The Pillar Two measures, however, appear to step away from this approach. Whether this is a step in the right direction is beyond the scope of this paper, but it is certainly a change

independently an enterprise of the state of which it is resident."

230 Harris (no 18), 68.

231 Norbert Herzig, Manuel Teschke and Christian Joisten, 'Between Extremes: Merging the Advantages of Separate Accounting and Unitary Taxation' (2010) 38:6 *Intertax* 334, 336.

232 Australia, for example, consolidates entities into their parent corporation, and imposes taxation on the parent as representative of the entire group. The OECD Model, on the other hand, applies the separate entity approach, and in consequence, so do most international tax treaties: "[Tax treaties] invariably recognise each member of a corporate group as a separate 'person'", Harris (no 18), 68, 72-73, 166.

233 For example. the separate entity principle has long been a part of international tax law's approach to the PE; Article 7(1) of the Model Tax Convention embodies the "functionally separate entity approach", in that the PE is treated as a separate entity to the parent company. See Model Convention (no 15), article 7(1) and OECD, '2010 Report on the Attribution of Profits to Permanent Establishments' (OECD, 22 July 2010),[49]-[50].

234 Harris (no 18), 166.

235 Herzig (no 231), 335: "separate accounting is the currently established system for international profit distribution".

that should be kept in mind when evaluating the Pillar Two measures.

4.5. Changing the Status Quo – But *Without* a Treaty

Reference must be made back to a particular line of argument brought up in relation to Pillar One, namely the idea that the new measures overrule the existing jurisdiction to tax principle and therefore do not cause any conflict within the field of international tax law. However, while this may apply to Pillar One and its source in treaty, the same cannot be said of Pillar Two. It is the intention of the OECD and participating states that the Pillar Two rules be implemented through domestic legislation.[236] As briefly mentioned, this is indeed what has been happening in the first part of 2023, albeit with differing timelines between states. The significance of this is that domestic legislation is not a source of international law, nor can it be considered to override existing international law.[237] Thus, the Pillar Two measures do not create new bases of jurisdiction, nor do they create exceptions to the existing norms. Domestic law cannot remove from a state obligations or responsibilities imposed by international law, and as this thesis argues, international law imposes the requirement of a sufficiently close connection between tax subject and taxing state.[238] Thus Pillar Two

[236]Patrick Marley, Amanda Heale and Ilana Ludwin, 'OECD Releases Model Rules for Global Minimum Tax' (*Osler*, 23 Dec 2021) <https://www.osler.com/en/resources/regulations/2021/oecd-releases-model-rules-for-global-minimum-tax> accessed 2 July 2023.

[237]European Commission for Democracy Through Law, *The Relationship Between International and Domestic Law* (1993) CDL-STD(1993)006, 4.9.b: "States should ensure that their domestic legislation – including statutes and administrative measures – is compatible with international customary rules and general legal principles."

[238]It feels necessary at this point to discuss briefly the relation between international law sources and domestic law. In the case of obligations imposed by treaty, international law is rather clear – see the Vienna Convention on the Law of Treaties (1969), article 27: "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty". The position of international customary law, however, is less consistently defined. Yet, customary international law cannot simply be overturned by enacting domestic legislation. This can be seen from the existence of the persistent objector principle: a state, in order to opt out from a rule of custom, must from the beginning of state practice make it known, consistently, that it does not consider itself to be bound by said rule. For more detail, see Vaughan Lowe, *International Law* (OUP, 2007), 55. Such principle demonstrates that customary international law obligations, once accepted through state practice, are binding upon states, and a state cannot simply opt out of existing obligations. Thus, regarding the nexus requirement, states cannot simply pass domestic legislation enacting the UTPR and treat this as an 'opt out' from the nexus requirement rule. In

must necessarily be in line with existing jurisdictional principles; as Vanderwolk has asserted, if Pillar Two is intended to change these principles, this should be explicitly recognised by the states involved, and a multilateral instrument drafted.[239]

It could be contended that the Pillar Two rules represent agreement by a majority of states, and thus should have some force in relation to customary international law.[240] However, as with many areas of tax law, the exact content of the rules as implemented by each state differs. This means that unanimous state practice cannot yet be claimed to exist. It is certainly possible that Pillar Two will form the basis for the development of customary international law, but such change has not yet happened.

4.6. Conclusion

The biggest changes to the international corporate income tax system imposed by Pillar Two will be the income inclusion rule and the under-taxed payments rule. Both of these rules create a right to tax where before none existed, thus expanding the jurisdiction to tax of the relevant states.

In the case of the IIR, the residence state of the parent company is able to impose tax upon the income of a foreign subsidiary, by requiring the parent company to include the income of the foreign subsidiary. This is controversial as there is no direct nexus connection, either in the form of a resident taxpayer or taxable income arising in the jurisdiction of the taxing state. However, once the IIR is compared to existing CFC rules, it becomes easier to understand how it can slot into existing international law. The CFC regimes have been accepted by the majority of states, and thus the legitimacy of such jurisdiction has become a part of customary law. Since the IIR functions in a similar manner, it is no great stretch to hold that the IIR also finds support in

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order to deviate from existing customary international law, a treaty should be enacted.

239 Vanderwolk (no 221), 1370.

240 Magalhães, 'Give Us the Law: Responses and Challenges to UTPR Resisters' (2022) Tax Notes Int'l 1257 – discussed in *ibid,* 1370: ("Magalhães and others have also suggested that the UTPR should be viewed as an acceptable new development in international taxation because a large number of countries signed the October 2021 statement on the two-pillar solution and subsequently agreed to the issuance of the GLOBE rules.")

the existence of CFC rules and does not represent a gross violation of international principles of jurisdiction. It is clear that changes need to be made to fix the current system, and the IIR steps in this direction without entirely throwing caution to the wind.

When it comes to the UTPR, however, it is much harder to find a sufficient connection between the taxing state and the income subject to taxation. The income being taxed is that of a subsidiary outside of the taxing state, linked only to the subject of taxation by the fact of indirect shared ownership. This cannot be considered a sufficient nexus, and thus the UTPR, unlike the IIR, cannot be considered to align with the doctrine of jurisdiction as it currently exists. The mismatch between the current corporate income taxation system and the digital economy has made it clear that change is needed; if the UTPR is to be implemented as is, it should be done through a treaty making explicit the intention of states to expand, or create an exception to, the principle of jurisdiction to tax.

Chapter 5. Conclusion

The overwhelming rise of multinational corporations (MNCs) since the beginning of the 18th century has exposed the flaws of the current taxation system. Due to the inherent flexibility of MNCs' corporate structuring, they are able to easily exploit base erosion and profit shifting measures, which leads to much-reduced revenue for states and distortion of the global economy. This issue has only been exacerbated by the rapid digitalisation of the economy, with the COVID-19 pandemic serving as the final straw for many states. In response, a large number of governments have taken unilateral measures, through the adoption of DSTs, for example, and such lack of uniformity across the globe has sparked tensions between states. To remedy the situation, the Organisation for Economic Co-operation and Development (OECD) has, as the culmination of several years of work, proposed a two-pillar solution. Pillar One consists of a new taxing right for market jurisdictions, which is not based on the traditional physical presence requirement (the permanent establishment rule (PE)) but rather upon economic presence in a jurisdiction. Pillar Two, on the other hand, imposes an effective minimum tax rate of 15 percent worldwide, through several rules which function to increase particular states' taxing rights. It is clear, therefore, that both measures raise very important issues relating to jurisdiction, since they each appear to expand a state's jurisdiction to tax in different directions.

The *Lotus* case remains the starting point for the rules of jurisdiction in general international law. In the case of enforcement jurisdiction, the court made it clear that extra-territorial exercise of jurisdiction by a state will require a permissive rule. Thus enforcement jurisdiction is limited. In the case of prescriptive jurisdiction, however, *Lotus* states that a state is only limited where a prohibitive rule exists. It is the view of this paper that such a rule does exist in the specific content of jurisdiction to tax. Thus it is argued that in the context of international tax law, jurisdiction to tax is limited, both in the prescriptive and enforcement sense. Following Avi-Yonah's thesis, customary law imposes a requirement of a "genuine link" or a "nexus" between the state and the income or person(s) subject to taxation.[241] It is recognised that the content of such a link is as yet rather open, and undefined, yet this does not mean that no link is required. In the

[241] Avi-Yonah (no 98), 4-5.

context of jurisdiction to tax, such link is found either through personal (or political) allegiance, which grounds residence-based jurisdiction, or through economic allegiance, which grounds source-based jurisdiction. Pillar One clearly expands states' jurisdiction to tax, since it creates a right to tax where there would, under the current system, be no jurisdiction to tax. This is done by a shift in focus from the physical presence requirement imposed by the PE concept to a requirement of "economic presence" instead. This paper has argued that there is no theoretical barrier to the use of economic presence in this manner; PE is simply a tool that has been used as proof of existence of economic allegiance. Thus, there is nothing to stop economic presence from providing such evidence. Pillar One's Amount A purports to use a revenue threshold to quantify economic presence and thus legitimise jurisdiction to tax. Despite criticism, it is held that a revenue threshold is a satisfactory method for establishing the existence of economic allegiance between an MNC and the state aiming to exercise taxing rights. State governments appear to follow this line of reasoning also, as demonstrated by wide use of revenue thresholds for digital service taxes. Thus, it is concluded by this paper that Amount A does not expand a state's jurisdiction to tax past the bounds of theoretical support, and therefore does not violate the principle of jurisdiction in international law.

Turning to Pillar Two, two particular rules are of import: the Income Inclusion Rule (IIR) and the Under-taxed Payments Rule (UTPR). Both are non-treaty based, intended to be implemented by states' domestic laws, and both expand jurisdiction to tax in different directions. The IIR allows the state in which a parent company is resident to exercise corporate tax over the income of a subsidiary in a different state; this is in conflict with the existing PE structure, and brings up issues regarding legal personality and whether subsidiaries are to be viewed as separate entities. However, the IIR displays strong similarities with already accepted and in-use Controlled Foreign Corporation (CFC) tax regimes. Both rules allow taxation of a parent company for income earned by a controlled subsidiary; the close connection in the case of these rules is that the parent company subject to tax is ultimately in control of the income being taxed. The fact that CFC rules are considered valid by states, and have been since the 1940s, means that opposition to the IIR loses its teeth. Thus this paper has argued that the IIR does not expand jurisdiction to tax in an unprecedented area, and should not be considered as violating jurisdictional principles.

The UTPR, on the other hand, allows an entirely unconnected third state to effectively exercise tax over the income of a subsidiary in another state, simply because an affiliated subsidiary exists in that state and the state of the parent company has chosen not to exercise the IIR. There is no economic allegiance here between the subject of the tax and the state exercising its taxing right. Thus, the UTPR finds itself in conflict with the principles of jurisdiction as laid out in this paper. It is therefore the position of this paper that Pillar Two should be implemented through an international treaty, which explicitly sets out the intention of states to create an exception to jurisdictional rules as they currently exist. Otherwise, domestic implementation of the UTPR as is currently planned will only lead to conflict between domestic laws and PIL, and lack of clarity as to what the acceptable bounds of jurisdiction to tax are to be.

To conclude, both Pillar One and Pillar Two raise many issues pertinent to jurisdiction; in particular, they both function to expand certain states' jurisdiction to tax. Thus, in order to legitimately do so, neither measure can be in conflict with the principle of jurisdiction under international law. It has been argued by this paper that international law requires a close connection, or genuine link, or nexus, between the subject of taxation, be it income or a person, and the state levying tax. From this point of view, this paper has attempted to analyse Pillar One and Pillar Two's conformity with the close connection doctrine. Pillar One's Amount A represents a departure from the traditional PE, physical presence approach that tax law has until this point followed. Despite this, it is a legitimate exercise of jurisdiction as there exists, in the form of economic presence and revenue, a sufficient connection between the taxpayer and the state. Pillar Two, on the other hand, is more problematic. The IIR is supported by state practice in the form of CFC tax regimes. The UTPR, on the other hand, as it is currently formulated, does not satisfy the requirement of a genuine link, since the state is taxing the income of a subsidiary that is located, and carries out its business, in an entirely different jurisdiction. It is therefore the recommendation of this paper that Pillar Two be implemented by a multilateral, legally-binding agreement between states; this will allow states to clearly signal that they are making a change to the current principles of jurisdiction to tax, in order to better adapt the taxation framework to the digitalised, multinational corporation-dominated corporate landscape that has developed.

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Abstract

경제협력개발기구(OECD) “Two Pillar Solution”의 조세 관할권 접근에 대한 이론적 분석

현재의 국제법인소득세 제도는 1960년대 초 설립 당시와 동일한 형태를 유지하고 있다. 거주지와 원천의 요소에 기반을 두고 과세할 관할권을 행사할 때 물리적 존재가 필수이다. 반면, 국제 기업 환경은 극적으로 변화했다. 경제의 빠른 디지털화로 인해 더 이상 효과적으로 기능하지 못하는 과세 시스템이 생겨났고, 결과적으로 국가들의 과세 관할권이 잠식되었다. 기업은 여러 관할권에서 동시에, 물리적인 존재 없이도, 운영할 수 있는 능력을 활용할 수 있다. 그런 전략을 채택함으로써, 국가 간에 기업이익을 이동하고 본사를 조세 피난처에 위치시킴을 비롯한 행으로 인위적으로 조세 부담을 줄인다. 이에 대응하여, 경제협력개발기구(OECD)는 압도적인 정치적 합의의 요청으로 2020년 10월에 'Two Pillar Solution' 해결책을 제안했다. 두 개의 'Pillar'로 구성된 이번 대책은 물리적인 존재가 없어도 관할 지역에서 이루어지는 매출에 대한 과세권(Pillar One의 Amount A)을 도입하고, 글로벌 최저 법인세율(Pillar Two)을 15%로 부과한다.

이 논문은 현행 국제세법은 법인소득세를 대상인 기업와 그 세금을 부과하는 국가 간의 밀접한 관계(close connection)를 필요한다고 주장한다. 이 밀접한 관계 요건은 국제세법의 맥락에서 관할 원칙의 기초를 형성한다. 제안된 Pillar One 및 Pillar Two 조치는 이러한 관할 원칙에 비추어 분석된다. Pillar One의 Amount A는 관할권의 범위를 확장하나 밀접한 관계 요건을 위반하는 데까지는 이르지 않는다. 따라서 이 논문은 Pillar One를 지지한다. Pillar Two와 관련하여, Income Inclusion Rule는 국가가 외국 자회사의 모법인에게 그 자회사의 소득을 자신의 세금신고에 포함하도록 요구할 수 있다는 것을 허용하는 규칙이다. 따라서 이미 존재하는 통제외국법인 과세규칙과 유사한 관할권 기반에서 기능한다. 결과적으로 관할 원칙 위반에 해당하지는 않는다고 본다. 반면에, Under-taxed Payments Rule는 과세된 소득과 세금을 부과하는 국가 사이에 직접적이나 간접적인 연관성이 없더라도 과세를 허용하는 것으로 보이기 때문에 여전히 문제로 남아 있다. 이 규칙은 이전을 하는 자회사가 15% 미만의 유효 세율을 적용받는다는 것을 근거로 국가가 동일한 모그룹의 자회사에 이전한 국경 간 지불에 대한 세액 공제를 거부할 수 있도록 허용하기 때문이다. 그럼으로 close connection 요건과 충돌한다. 이

논문은 국제 조세법의 현재 관할 원칙에 대한 예외 또는 확장을 명시적으로 만드는 조약으로 Pillar Two를 시행하는 것이 최선의 방법이라고 결론진다.

주요어: 법인소득세, 관할권, OECD, Pillar One, Pillar Two
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