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Revisiting an Age-Old Issue: What Taxes Should Be Treated as Income Taxes?

by Paul W. Oosterhuis

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In this article, Oosterhuis offers proposals for determining which taxes the multinational tax community can agree are properly imposed as income taxes and proposals for determining what taxes other countries should defer to, either through foreign tax credits or income exemptions.

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Let me first of all thank David Rosenbloom and all the members of the ITP Practice Council for inviting me to deliver the Tillinghast lecture this year. It is truly an honor. It brings back lots of memories — particularly of my time with the Joint Committee staff in the late 1970s, where I worked with David Rosenbloom during his stint as ITC at Treasury and also got to know David Tillinghast, who back then was active in bar association matters and in representing clients on international tax matters that involved legislation.

So again, thank you.

This is a propitious time to discuss what taxes should be treated as income taxes for two reasons. First, while the OECD Pillar 1 effort has not ended, I think it is fair to say it will not be successfully implemented in anything like its current form. Given a lack of business community and bipartisan Congressional support in the United States, and the fact that the proposal would not materially raise U.S. revenues, I very much doubt we could adopt it any time soon whether through multilateral instrument, treaty, or enabling legislation. And without the United States on board, the proposal cannot achieve sufficient approval in other countries to make its implementation feasible.

If that is correct, Pillar 1 will not deter most countries' digital services taxes (DSTs), and other similar revenue-based taxes will proliferate. That said, I think the Pillar 1 effort has not been a waste; it has taught us a lot about the direction that multilateral efforts to harmonize the taxation of cross-border income will take going forward. More on that later.

The second reason for my topic arose when, on July 21st of this year, our Treasury and IRS issued Notice 2023-55,[1] delaying the effective date of portions of the then-final foreign tax credit regulations[2] (the "2022 Final Regulations"). It temporarily reinstated reg. section 1.902-1(a) and (b) that in substance go back to regulations finalized in 1983[3] (the "1983 Final Regulations"), with a few exceptions that make certain that DSTs do not qualify as creditable income taxes under the net gain requirement of reg. section 1.901-2 or under the "in lieu of" standard under section 903.[4] That delay gives us an opportunity to rethink more broadly the regulations' cost recovery and attribution rules. I believe this rethink is important because our foreign tax creditability standard should not just reflect our own income tax rules but also the rules of other countries, at least where

[1] *See* Notice 2023-55, 2023-32 IRB 427.

[2] *See* T.D. 9959.

[3] *See* reg. section 1.902-1(a)-(b) (1983).

[4] Since the lecture was delivered, Treasury issued Notice 2023-80, 2023-52 IRB 1583, extending the delayed effective date indefinitely.

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there is a bilateral or multilateral consensus on the allocation and measurement of cross-border income.

Hence, the two sides to the question I pose are both what taxes should the multinational tax community agree are properly imposed as income taxes, and what taxes should other countries defer to either through foreign tax credits or income exemptions. Pillar 1 has grappled with the former through its treatment of withholding taxes and its attempt to persuade countries to forgo DSTs.[5] In addition to our foreign tax credit regulations, Pillar 2 deals with the latter side of the issue; its rules on what taxes are "covered taxes" involve the same issues as are dealt with in our sections 901 and 903 regulations.[6]

The issues of how to measure and allocate specific types of cross-border income are at the heart of my discussion. It will lead to a suggestion for a new initiative for the Inclusive Framework, perhaps together with the United Nations. That suggestion will then feed into a perspective for determining what taxes should be creditable under our section 901 and section 903 rules and, possibly, should be "covered taxes" under Pillar 2 for those countries implementing it.

I start by setting forth what I believe to be the first of two fundamental principles that should guide our thinking: Net income taxes are economically different than, and should be distinguished from, taxes on revenues. That may be obvious but is worth our focus. While I am no economist, I believe the principle is based on a pretty solid economic foundation: The incidence of net income taxes is different in substantial ways compared to revenue taxes. Economists who contemplated tax incidence in the post-World War I formative days of the income tax generally viewed net income taxes as borne by the earners of income while revenue taxes were borne by purchasers.[7] In today's world, the economic analysis of tax incidence has become more subtle. But I believe it is still fair to say that most economists see a difference: They view true net income taxes as borne by a mix of investors and labor while revenue taxes are borne in large part by purchasers, assuming at least in the case of a major tax increase or a new revenue tax, the central bank and local law allow for price increases corresponding to the tax increases.[8] A tax credit for foreign net income taxes thus maintains neutrality between purely domestic and cross-border economic activity, which I believe is a fundamental policy goal. A credit for revenue taxes against net income taxes is not consistent with that goal, and indeed can be a windfall to taxpayers who can in fact pass on much of the cost to customers.

I understand that economists can differ on the incidence of net income taxes versus revenue taxes.[9] And I respect the view of other commentators, including former Tillinghast lecturers, who do not share the policy goal of neutrality between domestic and foreign investment.[10] Nonetheless, my own view is that, in today's world, where so much cross-border economic activity is conducted through global rather than local business enterprises, it is important to distinguish between taxes on revenues and net income taxes.

But even those skeptical of my view can agree that in today's world we have the puzzling anomaly that some revenue taxes are treated as income taxes and others are not. Today, and throughout the past century, many revenue taxes have been imposed as tariffs on imports, or as excise, sales, or value added taxes when imposed

[5] *See* OECD, The Multilateral Convention to Implement Amount A of Pillar One (Oct. 2023). Withholding taxes are taken into account in determining the application of the marketing and distribution safe harbor under Article 5(2)(f); DSTs are agreed to be removed in Articles 38 and 39.

[6] For the definition of "covered taxes," see Article 4.2 of Tax Challenges Arising From the Digitalization of the Economy, Global Anti-Base Erosion Model Rules (Dec. 14, 2021).

[7] *See, e.g.*, Edwin R. Seligman, *Double Taxation and International Fiscal Cooperation*, at 78 (1928).

[8] For a good summary of the modern views on the incidence of the corporate income tax, see Kimberly A. Clausing, "In Search of Corporate Tax Incidences," 65 *Tax L. Rev.* 433 (Dec. 2011). Views on the incidence of revenue taxes, and in particular a VAT, are analyzed in Eric Toder, Jim Nunns, and Joseph Rosenberg, "Methodologies for Distributing at VAT," Tax Policy Center (Apr. 2011).

[9] *See, e.g.*, Jordan Berry and Ariel Jurow Kleiman, "Rationalizing the Arbitrary Foreign Tax Credit," 75 *Tax L. Rev.* 1 (Feb. 2021), arguing that some credit should be given for VATs.

[10] Michael J. Graetz, "The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax L. Rev.* 261 (2001); Daniel Shaviro, "Rethinking Foreign Tax Creditability," 63 *Nat'l Tax J.* 709 (2010).

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on transactions of residents. But some revenue taxes have long been treated as income taxes. The obvious example is withholding taxes imposed on the interest, rents, and royalties of nonresidents. A more subtle example, however, would be income taxes imposed on residents with respect to cross-border transactions where deductions are disallowed or limited in ways that effectively create taxes on revenues. Today, DSTs are the newest and fastest growing part of this landscape. If it becomes true that Pillar 1 ultimately does not deter DSTs, and other taxes on revenue grow, I believe they have the potential to disrupt our international tax consensus on income allocation and measurement. It is thus a good time to reexamine when and whether any revenue taxes should be treated as income taxes.

To pursue this examination, I'd like first to explore a bit of the history that got us to the place where some revenue taxes are treated as income taxes and others are not. I will then provide some evidence of the extent of their presence today beyond DSTs. That will lead to a discussion of how I think the Inclusive Framework and other multilateral forums should tackle this problem. Finally, I will discuss how this perspective should impact our thinking about foreign tax credits in the U.S. and about covered taxes in Pillar 2.

I am not going to discuss dividend withholding taxes because they can be differentiated from other revenue taxes depending on one's view of the connection between shareholder taxes and corporate income.[11] I am also not going to discuss withholding taxes on interest payments, given taxpayer flexibility in designing corporate capital structures and the resulting governmental base erosion concerns.[12] I do think interest withholding taxes should be reexamined in today's world, but that is a topic for another day.[13] Today, my focus is limited to withholding taxes on rents, royalties, and services — and principally the latter two.

Let's start with a brief historical look at these three withholding taxes. Tracing back to the development of income taxes after World War I, many countries treated rents as sourced at the location of the property, based on the location of tangible property.[14] Royalties tagged along with rents.[15] Services were sourced where performed, also based on clear physical nexus considerations.[16]

The sourcing rules for rents back then made intuitive sense: By definition, the use of tangible property in a country requires some physical presence in that country. The sourcing of services also made sense: Apart from communications and transportation services, where there were special rules almost from the beginning, most services were performed by people and not machines; taxing them on a net income basis at the location of the people made intuitive sense.

But royalties are different than rents. They require no physical presence; any presence is best described as legal, which is not a presence that otherwise matters for income taxation. In my review of the historical literature, I found little if any discussion focusing on this difference. Even when T.S. Adams walked the Senate Finance Committee members through the new source rules proposed for the Revenue Act of 1921, he consistently described rents and royalties in the same sentence, as payments for the use of property, making no effort to distinguish between them.[17]

So rents and royalties were pretty uniformly sourced in the country where the property was

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[11] For an insightful perspective on the connection between the two taxes in the United States, see William D. Andrews, "Out of Earnings and Profit: Some Reflections on the Taxation of Dividends," 69 *Harv. L. Rev.* 1403 (1956).

[12] While third-party transactions should generally not be viewed as base-eroding, the often discretionary nature of the allocation and amount of debt financing makes interest an exception.

[13] For example, even those countries that enact robust interest deduction limitations could desire to discourage borrowing from foreign lenders for currency management purposes.

[14] *See* Revenue Act of 1921, ch. 136, section 217(a), P.L. 67-98, 42 Stat. 227, 243-244 (1921); *see also* Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke L. J.* 1021, 1054 n.133 (1997) ("Rental and royalty income from tangible property was sourced to where the property was situated.").

[15] *See* Graetz and O'Hear, *supra* note 14, at 1054 n.133.

[16] *See* Revenue Act of 1921, section 217(a), 42 Stat. at 243-244 (1921); *see also* League of Nations, "Report on Double Taxation Submitted to the Financial Committee," Doc. E.F.S. 73 F.19, 40 (1923).

[17] Hearings on H.R. 8245 Before the Senate Committee on Finance, 67th Cong. 29 (1921) (statement of Dr. T.S. Adams, advisor to the Treasury Department). It is fascinating that T.S. Adams spent 18 days in the fall of 1921 going over the 1921 act section by section with lots of questions directly from committee members. Transcripts make no mention of staff. For comparison, think of the 2017 Tax Cuts and Jobs Act, where not only did members not read what was in the bill, they were actually misled in some circumstances about its application.

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"used" in some sense going back to the 1920s. In some countries, such as Great Britain and France, these sourcing rules were applied to scheduler taxes on revenues that existed before broad-based taxes on net income were adopted.[18] These scheduler taxes were final taxes that were withheld by payors. For residents these scheduler taxes were eventually folded into their broader net income tax, but they remained final withholding taxes for nonresidents.[19] That path, however, was not followed by all major countries. While the United States followed the same sourcing rules in the 1921 Revenue Act, our 8 percent nonresident withholding tax was not a final tax; nonresident taxpayers could file a net income tax return and seek a refund.[20] It was not until 1936 that we adopted our withholding taxes as final taxes.[21] Similarly, for its federal income tax, Germany permitted nonresident taxpayers to file a net income tax return to reduce withholding taxes in most circumstances until 1934 and in limited circumstances beyond that until 1958.[22]

Historically, a withholding tax on revenues from rents has been justified because taxpayers could readily structure their affairs to be subject to net income tax if that were a lower tax amount.[23] For royalties, the same rationale does not apply; such structuring typically requires significant changes in the nature of local operations.[24] The most persuasive justification seems to have been two-fold: Lower withholding tax rates made that tax more or less the equivalent in amount to a net income tax, and the presence of local competition would prevent taxpayers from passing the tax on to royalty payors in a manner more parallel to excise or sales taxes than to net income taxes.[25]

Today, of course, royalty withholding taxes remain on the statutory books as final taxes in most countries. Yet in my view neither condition for their justification holds. While some developed country treaties eliminate royalty withholding taxes, many treaties permit them at somewhat reduced but nonetheless substantial rates. I believe these statutory and treaty withholding rates on royalties have not been proportionately reduced given the substantial reductions in net income tax rates. I tried to find a source that could illustrate how withholding tax rates have not been lowered along with lower corporate net income tax rates over the past 25 years, but I could not find one. What I did find was that the OECD did a survey of the statutory withholding rates of its members and other countries in the Inclusive Framework in 2022 and published its first guide analyzing withholding rates on various types of income.[26] The survey included 38 OECD members and 74 other participants. Only 18 of the 112 countries surveyed do not impose a statutory withholding tax on royalties, and most of them are "investment hubs" (to use OECD terminology for tax-favored jurisdictions).[27] The OECD divides other countries into the categories of "low- and middle-income" jurisdictions and "high-income" jurisdictions. For the former, the average withholding rate is around 16 percent, with a range from 10 to 20 percent.[28] For the latter, the average is closer to 15

[18] *See* Income Tax Act 1803, an Act for the granting to his Majesty, until the sixth Day of May next after the Ratification of a Definitive Treaty of Peace, a Contribution on the Profits arising from Property, Professions, Trades and Offices (43 Geo 3 c 122, 1803). This is the act of Parliament promulgated by Addington that is widely credited with the introduction of the schedular system of taxation in Great Britain. For France, see Loi Portant Suppression des Contributions Personnelle-Mobilière, des Portes et Fenêtres et es Patentes et Etablissement d'un Impôt sur Diverses Categories de Revenus du 31 Juillet 1917, Nouvelles Contributions Directes, Impôts sur les Revenus.

[19] *Id.*

[20] *See* Revenue Act of 1921, section 221, P.L. 67-98, 42 Stat. 227, 248-249 (1921); *see also* Graetz and O'Hear, *supra* note 14, at 1054 n.133.

[21] Revenue Act of 1936, sections 211 and 213, P.L. 74-740, 49 Stat. 1648, 1714-1716 (1936).

[22] With the introduction of section 50a of the German Income Tax Act in 1958, filing net income tax returns was no longer permitted, and the withholding tax applied to the gross income. According to the legislature, such gross taxation was justified due to the lower tax rates for the withholding tax. *See* German Parliament BT/Drucks. 260-261.

[23] See discussion in the context of the United States adopting a specific election for trade or business taxation of real estate in the Foreign Investors Tax Act of 1966, in David R. Tillinghast, "The Foreign Investors Tax Act of 1966," 20 *Bull. ABA Section on Taxation* 87, 95-96 (Jan. 1967).

[24] Typically, for traditional manufacturers and sellers of goods, planning to avoid paying a royalty requires importing the final product into a country rather than conducting manufacturing or even packaging locally.

[25] *See* Stanley Surrey, "Current in the Taxation of Corporate Foreign Investment," 56 *Colum. L. Rev.* 816, 821 (1956).

[26] *See* OECD, *Corporate Tax Statistics* (2022).

[27] *Id*. at 45.

[28] *Id*. at 50.

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percent but over a third of the countries having rates between 20 and 30 percent.[29]

I submit that in today's world these rates of withholding taxes imposed on royalties by all but "investment hubs" cannot be justified as a substitute for a net income tax. As the OECD data show, most royalty withholding rates are in the 15 to 20 percent range, with a significant number — including the U.S., Belgium, and Italy — as high as 30 percent.[30] While I could not find a comprehensive source, most treaties that permit withholding taxes on royalty income do so at a 10 percent or higher rate.[31] In a world where our domestic corporate net income tax rate is 21 percent and the OECD average rate is close to 25 percent,[32] I suspect few royalty recipients are paying less in withholding tax at statutory or even treaty rates than they would pay were they subject to net income tax rates on their taxable income.

A simple example can illustrate this point. A company with a 25 percent operating margin has $1 million of revenue and $250,000 of pretax profit. Applying a 10 percent withholding tax on $1 million translates into equivalent of a 40 percent tax on operating income. Very few countries impose their net income tax at that rate today.

Moreover, the second prong of the justification — that local competition will prevent royalty recipients from passing a large portion of the tax on to their customers — seems unlikely in today's world where the main royalty recipients are technology and pharmaceutical multinational companies that compete with each other and not with local companies. In these circumstances arguably the withholding tax acts much more like a tariff or excise tax than an income tax.

I don't mean to overstate the magnitude of the problem; as mentioned above, some tax treaties between high-income jurisdictions eliminate the withholding tax on royalties.[33] And in low- and medium-income jurisdictions that impose higher-rate withholding taxes on royalties, multinationals that deal in physical goods can often avoid the tax by structuring their manufacturing or other activities to avoid transfers of IP to those countries. The latest IRS Statistics of Income data for foreign tax credits claimed by U.S. taxpayers illustrate these facts. They show that in 2020 U.S. taxpayers directly earned about $171 billion of general basket, non-subpart F royalty gross income but paid less than $7 billion in creditable foreign taxes on that income.[34] These data, though, need to be taken with some skepticism: They only cover foreign taxes paid directly by U.S. corporate taxpayers, not those paid by CFCs or unincorporated taxpayers.

Whatever the current impact of royalty withholding taxes generally, for the high tech world involving transfers of software, which can be seen as 10 percent of our economy today and growing rapidly, the problem is a relatively large one.[35] We saw that over the past three years as our high tech companies vigorously objected to the 2022 Final Regulations provisions on nonresident royalties.[36] Those objections were understandable because under the 1983 Final Regulations and our current section 904 rules, taxpayers could credit these withholding taxes against the general basket royalty income earned from all countries, including those that provide a withholding tax exemption. My conclusion from this is that, as the high tech world encompasses a broader share of our economy, the persistence of royalty withholding taxes is a significant problem generally and a particular problem for software-based economic activities.

The problem has been somewhat masked by our foreign tax credit rules, which allow cross-

[29] *Id.* at 51.

[30] *Id.* at 52.

[31] As an example, 33 U.S. treaties permit withholding taxes on royalties; of them only four treaties establish a rate lower than 10 percent on most types of royalty income. *See* IRS Tax Treaty Table 1 (rev. May 2023).

[32] *See* OECD, *supra* note 26, at 13.

[33] *See* IRS Pub. Table 1 — Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties (rev. May 2023) (stating that 20 of 53 bilateral U.S. income tax treaties eliminate the withholding tax on royalties, including high-income jurisdictions such as France, Germany, Japan, and the United Kingdom).

[34] For a thorough analysis of U.S. taxpayer income and credits, see Table 3, IRS SOI Tax Stats — Corporate Foreign Tax Credit Statistics (Sept. 30, 2023).

[35] *See* Baker & McKenzie IRS comment letter, on behalf of the Software Coalition, regarding guidance on the foreign tax credit (Feb. 9, 2021).

[36] *Id.*

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crediting of high withholding tax and no withheld tax royalties. We should address it but do so in a manner that goes beyond merely denying creditability based on our notions of where IP is used.

Now let's discuss withholding taxes imposed on services. These taxes do not have a history going back to the 1920s. I haven't been able to identify exactly when they started, but India imposed a withholding tax on "technical" services going back to 1961.[37] By 1983 these types of taxes were prominent enough to warrant a specific reference in the 1983 Final Regulations, which made clear that nonresident services withholding taxes were creditable under section 903.[38] The United Nations Model Treaty added Article 12A in 2017 after several years of discussion recognizing that low- and middle-income countries impose "technical" services withholding taxes, which are defined to include management and advisory-type services.[39]

Today, while treaties permitting withholding taxes on services are not yet prominent, a surprisingly large number of countries impose some statutory services withholding taxes. The OECD survey for 2022 separately breaks out statutory withholding taxes on "technical services" and "management services."[40] According to the data, one-half of OECD members and over two-thirds of non-members surveyed have some form of statutory withholding tax on both technical and management services.[41] Similarly, a survey of 120 countries conducted the same year by Baker & McKenzie, as part of their representation of the U.S. software coalition, found that 72 of them imposed meaningful services withholding taxes.[42]

The impact of these services withholding taxes seems modest as of 2020. The latest IRS Statistics of Income data suggest that in 2020 U.S. corporate taxpayers paid between $2 billion and $3 billion of foreign taxes attributable to services income and eligible to be claimed as credits in the general basket.[43] Not a large number. Note, however, that these are only the taxes imposed directly on U.S. corporate taxpayers; partnerships of individuals and taxes on subpart F inclusions are not identified. Moreover, if you just add up the section 901 foreign tax credits claimed directly by U.S. corporate taxpayers on royalties and services, the total for 2020 approaches $8 billion to $9 billion per year, which over a 10-year forward-looking budget period could well mean more than $100 billion in lost revenue.

To be clear, most of these services withholding taxes are the types of taxes blessed by U.N. Model Treaty Article 12A. They are not DSTs. Few DSTs were in effect in 2020.[44] Moreover, many DSTs are imposed outside of, and at least in form in addition to, any income taxes imposed by a jurisdiction. The French and English DSTs, for example, in form apply to residents as well as nonresidents and, if paid by residents, are deductible against local income tax liability.[45] That makes their eligibility for the foreign tax credit suspect even if the old 1983 Final Regulations governed.[46] Here too, India is an exception. In 2020 it enacted a DST, called an Equalization Levy, that is imposed only on nonresidents and is in form an extension of their income tax.[47] It is just another form of a withholding tax on nonresident services and is creditable under the regulations after Notice 2023-55. If Pillar 1 does not succeed,

[37] *See* India's Income Tax Department, "Royalty and Fees for Technical Services," Taxpayer Information Series 44, at 1058 (July 2013), referring to the Income Tax Act, 1961.

[38] *See* reg. section 1.903-1(b)(3), Example 3 (1983).

[39] United Nations Model Double Taxation Convention Between Developed and Developing Countries (2017), Article 12A, para. 3. (UNMTC).

[40] *See* OECD, "Standard Withholding Tax Rates."

[41] *Id*.

[42] *See* Baker & McKenzie, *supra* note 35.

[43] *See* IRS SOI Tax Stats — Corporate Foreign Tax Credit Statistics (Sept. 30, 2023).

[44] *See* Andres B. Schwarzenberg, "Section 301 Investigations: Foreign Digital Services Taxes (DSTs)," at 2, Congressional Research Service, IF11564 (rev. Mar. 1, 2021) (listing countries that adopted DSTs, including Austria, India, Indonesia, Italy, Spain, Turkey, and the United Kingdom, with respect to which the U.S. Trade Representative launched investigations under section 301 of the Trade Act of 1974).

[45] *See* Office of the U.S. Trade Representative, "Section 301 Investigation: Report on France's Digital Services Tax," at 47-49 (Dec. 2, 2019); and Office of the U.S. Trade Representative, "Section 301 Investigation: Report on the United Kingdom's Digital Services Tax," at 31 (Jan. 13, 2021).

[46] The DSTs do not qualify as in lieu of taxes under section 903 because they are in addition to rather than in lieu of income taxes for residents; they do not qualify as an income tax under the cost recovery provisions of the reg. section 1.901-2 regulations because they do not allow the recovery of any expenses.

[47] *See* Office of the U.S. Trade Representative, "Section 301 Investigation: Report on India's Digital Services Tax" (Jan. 6, 2021).

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and DSTs become more prevalent, I predict the Indian tax is a model other countries will emulate.

As is the case with royalty withholding taxes, withholding taxes on non-DST services cannot be justified as a proxy for a net income tax. The OECD data indicate that services withholding tax rates outside of investment hubs range from 10 to 35 percent. And given that many types of services are charged out on a cost or cost-plus basis, the resulting net income is relatively small. Many taxpayers charge out services at a cost-plus 10 percent or less basis.[48] If the services reflect $100 of cost, the affiliate is charged $110, leaving $10 of profit. A 10 percent withholding tax on the $110 of revenue more than wipes out that profit.

Ironically it is possible the same cannot be said of most DSTs. Since they apply to customer transactions, company margins can be relatively high, and most of the DST tax rates are relatively low. The 3 percent French DST imposed on a company with a 25 percent net margin is the equivalent to a 12 percent net income tax.

In today's world the desire to impose some tax on nonresident digital and other types of nonresident services income is understandable for a number of reasons. First, the line between technical services and royalties in B2B transactions has always been difficult to draw in practice.[49] In today's internet world these difficulties increasingly apply to consumer transactions as well. The distinction between characterizing a particular activity as a service versus a rent or a royalty is increasingly arbitrary; only lawyers can appreciate that subscription payments to a content provider are rents or royalties if the content can be downloaded for a period of time but are service fees if only accessible from the internet.[50] To have radically different tax consequences to the earner of that payment based on the details of the rights transferred or the method of delivery makes little sense to most observers. Moreover, today a broad range of services that we have traditionally considered to be "personal" are becoming automated and can often be delivered remotely. The advances of artificial intelligence in law and accounting services, for example, are likely to make even those services less "personal" in the sense of people activity, and more machine-driven over the next five to 10 years.[51]

All of these considerations motivate the low- and medium-income countries in particular to view withholding taxes as an appropriate tax policy for a wide variety of services transactions even where the withholding tax potentially imposes high effective income tax rates on most service providers. Under the 1983 Final Regulations, U.S. taxpayers can claim and often realize a foreign tax credit for the tax no matter how high the rate.[52] Some service providers, like royalty recipients, often have "room" in their general basket for section 901 credits and for section 960 credits on subpart F services income. Others may not. All of this tells me that the problem of revenue taxes on services is becoming real for both taxpayers and our Treasury, and will only grow if Pillar 1 does not succeed and variations of DSTs and other revenue taxes proliferate.

As we think about these issues, we in the United States need to be reminded that, while the 2022 Final Regulations overreached in requiring foreign tax rules to mirror ours, our current rules are in many ways more generous in allowing credits and cross-crediting than those of other countries. The U.K. permits foreign tax credits for nonresident royalty and services withholding taxes imposed on U.K. residents, but only to the extent of the U.K. tax rate on the net income resulting from that item of revenue.[53] If a U.K. resident pays a $10 withholding tax on $100 of royalty revenues and has $70 of expenses directly

[48] As an illustration, the Pillar 2 model rules mark up payroll by 8 percent initially and ultimately 5 percent for purposes of calculating the substance-based exclusion from its IIR, QDMTT, and UTPR amounts. *See* Article 5.3.

[49] *See* U.N. Committee of Experts on International Cooperation in Tax Matters, 14th session, "Revised Commentary on Article 12A — Fees for Technical Services" (Mar. 2017).

[50] *See, e.g.*, prop. reg. section 1.861-19 (2019).

[51] *See, e.g.*, Ryan Abbott and Bret Bogenschneider, "Should Robots Pay Taxes? Tax Policy in the Age of Automation," 12 *Harv. L. & Pol'y Rev.* 145 (2018) (illustrating the current impact of automation and arguing the need for tax policy in the automation debate); Jay A. Soled and Kathleen DeLaney Thomas, "Automation and the Income Tax," 10 *Colum. J. Tax L.* 1 (2018) (exploring ways that automation has impacted our tax system).

[52] For U.S. taxpayers, the foreign tax would typically be creditable in the general basket under reg. section 1.904-6; even if imposed on U.S.-source income, taxpayers could use that credit to the extent they have general basket foreign-source royalty or other income.

[53] *See* Ernst & Young, "Worldwide Corporate Tax Guide," at 373-374 (Aug. 2023).

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attributable to those revenues (e.g. because of an in-license of the IP), the tax credit is limited to $30 of net income times its 25 percent corporate rate, so only $7.5 can be taken as a credit. Germany is similar to the U.K. for royalty withholding taxes but does not allow any credit for services withholding taxes because the services income is not regarded as foreign-source.[54] France does not allow any credit for either royalty or services withholding taxes outside of its treaties, and treaty withholding tax credits are similarly limited to the net income created from the item of revenues.[55] As these examples illustrate, our foreign tax credit limitation rules can often be relatively generous; it is often the case that our combining of revenues in the general basket gives taxpayers ample room to take credits even though we do allocate indirect expenses like interest and R&D in the basket net income calculation.

As I mentioned at the outset, while nonresident withholding taxes are the most obvious form of revenue tax that is treated as an income tax, taxes that are in form net income taxes on residents can be equivalent in various scenarios. Some countries, for example, disallow deductions for operating expenses like royalties and services fees where they are not subject to withholding tax or are subject to reduced rates of withholding.[56] To my surprise, many of these are not limited to related-party payments, where base erosion concerns can be real because of transfer pricing frailties; they apply also to cross-border royalty and services payments to third parties where base erosion is not a proper concern.[57]

In these cases where expenses are disallowed to unrelated as well as related parties, the disallowance to a local entity that is profitable and paying local resident income tax can be the economic equivalent of granting the deduction but imposing a withholding tax. Some countries, in fact, coordinate their deduction disallowances with their rate of withholding tax. In Argentina, for example, its 35 percent withholding tax on royalty payments generally is reduced to 28 percent for trademark royalties.[58] At the same time Argentina disallows 20 percent of any deduction against its 35 percent net income tax for cross-border trademark royalties subject to that withholding tax, whether paid to related or unrelated parties.[59] That disallowance effectively neutralizes the lower withholding tax rate.

The lesson to be learned from these deduction disallowance provisions is that if an effort to reduce or eliminate withholding taxes on royalties and services is to be successful, it should be matched with provisions that require a full deduction for those payments, subject to any transfer pricing limitations applicable to related-party transactions. Otherwise, limitations on withholding taxes could become meaningless.

Hopefully, by now I have persuaded you that many situations exist where taxes labeled income taxes are to one extent or the other, actually or effectively taxes on revenues that arguably should not be viewed as income taxes. The magnitude of the problem is significant today and likely to increase substantially going forward. Now is a good time to address their treatment as income taxes.

But what should we do? It is not realistic to push for an international consensus to eliminate these taxes and cede taxing rights fully to the income recipient jurisdiction. For low- and medium-income countries there is already substantial revenue involved. Moreover, some level of taxation based on the location of the royalty licensee and service recipient can be justified by considerations similar to those justifying Pillar 1 income allocations and

[54]The catalog of German-source income does not include services income unless such income is related to other German-source income. *See* section 49 of the German Income Tax Act.

[55]*See* Code General des Impôts, art. 39, 1-4; CE June 18, 2021, n 433315, 9e et 10e ch., (Sté Sopra Steria Group).

[56]For example, in Colombia, costs incurred outside of the country (*e.g.*, for royalties, technical services, technical assistance, and interest) that are not subject to Colombian withholding taxes are deductible only to the extent such costs do not exceed 15 percent of the taxpayer's net income (before accounting for such costs). The limitation does not apply to costs for acquiring tangible property, but it *does* apply to payments for any services rendered outside of Colombia and interest paid on publicly traded debt. *See* Taxation (International and Other Provisions) Act 2010, section 36(2) for income tax purposes and section 42(2) for corporation tax purposes.

[57]I realize not everyone believes base erosion is limited to related-party expenses; they are more concerned about conduit and other indirect arrangements with third parties. But in my experience, conduit-type arrangements are relatively infrequent, so disallowing third-party expenses as "base erosion" is overreaching.

[58]*See*, *e.g.*, Orbitax, "Argentina — Orbitax Country Chapters" (Nov. 28, 2023).

[59]*Id*.

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destination-based taxation more generally.[60] We could attempt to persuade withholding-tax-imposing countries that the withholding rates should be reduced to a level closer to that of DSTs, which would be less than 5 percent, so that in many cases the tax burden would not exceed a net income tax liability. But given the wide variety of services that are subject to the tax, such a one-size-fits-all approach would overtax some service providers (e.g. internal management service providers) and under-tax others (e.g. most internet services providers). We need a more creative approach to the problem.

Thinking about a more creative approach leads me to my second principle: While we should insist that income taxes only include taxes on net income, we should be flexible on the level at which net income is measured and how it is allocated among taxing jurisdictions. We are best served if we establish a goal of encouraging jurisdictions to agree on almost any reasonable net income measure and allocation that avoids overlapping taxation of cross-border income.

To further that goal, I believe the Inclusive Framework and possibly the United Nations should undertake a new project, which would acknowledge the appropriateness of taxing a portion of the income from a broad range of nonresident services and royalties in the income payor jurisdiction, but only by adopting the concept behind U.N. Model Treaty Article 12B.[61] That Article provides for a withholding tax on digital services but gives service providers the option to file on a net income basis. The withholding tax becomes a stick to persuade taxpayers to volunteer to be subject to net income tax.

The Inclusive Framework should consider applying this concept not just to digital services but to broader categories of services — and to royalties generally — and to consider adopting it through a multilateral instrument in addition to its Model Treaty. The goal would be to establish a new international consensus permitting withholding taxes on royalties and services, but only where taxpayers are given an option to file net income tax returns and allocate at least a portion of their net income to the payor jurisdiction. As part of the consensus, DSTs would be withdrawn if not converted into a broader nonresident services withholding tax with a net income tax election.

Of course, U.N. Article 12B does not propose to measure the net income amount for its provision through arm's-length pricing. Instead, it adopts a formulary split of group business segment net income based on the overall profitability of the segment. Specifically, it first provides that worldwide operating profits of the business segment be determined as a percentage of worldwide business segment revenues.[62] That percentage is then applied to local revenues. Thirty percent of that amount is determined to be the net income subject to tax in the payor jurisdiction; the 30 percent allocation reflects an arbitrary split of that deemed net profit between the service recipient jurisdiction and the service provider jurisdiction.[63]

The U.N.'s use of an arbitrary, profit split formula reflects the skepticism of many active in that body regarding the viability of arm's-length pricing. Yet one of the important lessons from the Pillar 1 experience is that a similar skepticism of arm's-length pricing is shared by most participants in the Inclusive Framework. By consensus, Pillar 1 uses formulas for both Amount A's allocation of income and Amount B's measurement of income.[64] In fact, the Amount A formula is not that dissimilar from that applied in Article 12B. It just applies to profits in excess of 10 percent of revenue rather than 30 percent of all profits.

On this point I would like to pause for a moment. I have long been a critic of the formulary apportionment of income in the cross-border context at the same time that I have advocated for the goal of expanding destination-based taxation. I helped write several descriptions of how to

[60] For arguments in favor of destination-based income taxation, see generally Michael P. Devereux et al., *Taxing Profit in a Global Economy*, ch. 6 (Jan. 2021).

[61] United Nations Model Double Taxation Convention Between Developed and Developing Countries (2020), Article 12B.

[62] *Id.* at para. 3.

[63] *Id.* at para. 50.

[64] *See* OECD, "The Multilateral Connection to Implement Amount A of Pillar One, Article 5 and OECD Public Consultation Document Pillar One-Amount B" (July 17, 2023).

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achieve that goal through modifications to transfer pricing ground rules,[65] including most recently in the 2021 book *Taxing Profit in a Global Economy*, which I co-authored with Mike Devereaux and four others.[66] But even before the book was published, I came to realize that most governments and most in the business community are unwilling to achieve the goal of enhancing destination or market income allocations through changes to transfer pricing. The consistent message has been to achieve that goal by adopting formulas that avoid arm's-length determinations.[67]

From this, I believe the Pillar 1 experience teaches us two lessons relevant here. First, some type of formulaic measurement of net income with respect to nonresident royalties and services should be the focus and, second, achieving a consensus on one or more formulas may be more realistic than most of us would have ever thought possible five years ago. Any formulas would of necessity expand beyond the one proposed in Article 12B, if for no other reason than because that formula applies only to third-party customer transactions and the net income measurement here would apply to intercompany transactions as well.[68] But the Article 12B profit split formula is a reasonable starting point; its formula, like Amount A in Pillar 1, apportions financial statement income, which of course is truly a net income number, and does it in a simple, comprehendible manner similar to Amount A from Pillar 1.

Why is it in the interests of the U.S. to promote a broad Article 12B proposal? Given our trade surplus in services, which includes rents and royalties, it could cost us revenues if we adjust our services source rules and allow a foreign tax credit.[69] But we could continue to take the position that our treaties should eliminate any tax on nonresident royalties and services. We could then treat the Article 12B proposal as a fallback to apply to those countries, principally low- and middle-income countries, that otherwise insist on having withholding taxes on some types of rents, royalties, and services. In that context, if we continue to delay, and particularly if we were to revoke the attribution and cost recovery rules in the Final 2022 Regulations, retaining those portions of the relatively liberal 1983 Final Regulations (as I think we should do in any case) revenues from the credits taxpayers receive today for existing withholding taxes on royalties and services would be part of the budget baseline and help fund the new net income allocation and net income tax credit provisions. That might not be such a revenue-losing proposition.

It is true we are unlikely to sign a multilateral instrument or get Senate approval for tax treaties with low- and middle-income countries to adopt this provision. But we could look at the recently proposed House Ways and Means and Senate Finance Committee Taiwan legislation as a model. That legislation proposes to implement for Taiwanese residents permanent establishment-type trade or business rules and reduce withholding rates where the Treasury Secretary certifies that Taiwan has comparable provisions for U.S. residents.[70] Adopting legislation to allow the election of a net income tax alternative to our withholding tax with respect to countries that have adopted similar rules for royalties and, where applicable, services, could circumvent our broken tax treaty process. And, if we also limit our foreign tax credit to the net income taxes of countries implementing comparable provisions, so that withholding taxes on royalties and services would not otherwise be creditable, any revenue loss should be modest.

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[65] These writings include Joe Andres and Paul Oosterhuis, "Transfer Pricing After BEPS: Where We Are and Where We Should Be Going," *Taxes Magazine*, at 87 (Mar. 2017); and Oosterhuis and Amanda Parsons, "Destination-Based Income Taxation: Neither Principled Nor Practical?" 71 *Tax L. Rev.* 515 (2018).

[66] *See* Devereux et al., *supra* note 60.

[67] I first realized the emphasis on formulas while participating in an OECD public consultation on Pillar 1 in March of 2019 during which various companies proposed formulaic income allocations. *See* Ryan Finlay, "Practitioners Urge Caution in OECD Digital Economy Work," *Tax Notes Int'l*, Mar. 18, 2019, p. 1209. *See also* Francois Chadwick, "International Tax Rules for the Digital Era," *Tax Notes Federal*, Aug. 19, 2019, p. 1245.

[68] A formula for intercompany transactions could, for example, be based on a mark-up of costs and return on assets similar to the substance-based exclusion in Pillar 2. *See supra* note 48.

[69] *See* Bureau of Economic Analysis, "U.S. International Trade in Goods and Services," exhibits 3-4 (Nov. 7, 2023) (for example, in 2022, the United States exported $928,530 million total services compared to imports of $696,707 million total services, leaving a surplus in our balance of services equal to $231,823 million).

[70] *See, e.g.*, Asha Glover, "Senate Committee Agree With House on Taiwan Tax Bill," Law360 (Nov. 29, 2023). Since the lecture was delivered, the House Ways and Means Committee approved H.R. 5988, the Title I Tax Relief Bill incorporating this agreement.

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So I believe an effort to adopt a version of U.N. Article 12B applicable to royalty and services withholding taxes could be the next project for the OECD Inclusive Framework, possibly together with the United Nations. But, as I mentioned at the outset, in parallel with that project we should consider a few additional changes to our section 901 and section 903 statutory provisions to limit the creditability of revenue taxes.

First, our section 903 "in lieu of" credit is too broad.[71] If we proceed with an Article 12B-type legislative proposal, we should exclude royalty and services withholding taxes, at least, from its scope. That pretty clearly requires a narrowing of the statute. Moreover, I am bothered by the fact that the statute and regulations currently permit revenue and other non-income taxes to be creditable without regard to whether they yield an amount of tax that bears any relation to a rational net income tax amount. In 1980 Treasury issued temporary regulations that limited the section 903 credit to taxes that were "comparable" in amount to a net income tax.[72] That limit did not survive in the final regulations, apparently because taxpayers pointed out that in many cases where the provision was intended to apply, like insurance premium excise taxes, the reason for the in lieu of tax was difficulty in computing net income.[73] A comparability requirement was thus argued to be unworkable. Moreover, given the plain language of the statute, it is not clear Treasury had authority to impose such a limitation.[74] So as a part of the legislation narrowing the provision, I would consider amending section 903 to add an express comparability requirement.

If we do these things to limit withholding taxes on royalties and services, we can then focus on whether we need address resident income taxes that mimic revenue taxes through various cost recovery disallowances and limitations. I believe addressing these issues requires effectively rethinking our standard that foreign income taxes must be income taxes "in the U.S. sense," coming out of the dictum in the *Biddle* case.[75] The conventional interpretation of that standard is that we must look at the foreign income tax as a whole and not its specific application to specific taxpayers in judging creditability. That interpretation is what has tied Treasury and the IRS in knots in their most recent efforts to deal with revised cost recovery requirements in particular. Treasury understandably wanted to do away with the "predominant character" test of the old regulations because it required a subjective empirical analysis.[76] But once done away with, Treasury had to face many situations of "small tails wagging potentially large dogs," to use the terminology we used in our ongoing discussions with Treasury and the IRS over the past several years. It cannot be that, just because the Taiwan income tax disallows deductions for overtime wages[77] or because Argentina disallows 20 percent of trademark royalty deductions,[78] each income tax as applied to all taxpayers is not a creditable tax. Treasury tried to solve the problem through safe harbors, which in fact covered these two examples, but they could not cover everything.[79] And they left us clueless as to any principle that will guide the consideration of what limitations outside the safe harbors might be consistent with creditability.

The alternative to the "income tax as a whole" concept is to take what I call a more targeted "rifle shot" approach by disallowing credits for taxes attributable to specified deduction disallowances or limitations. Only the foreign tax attributable to those items or those taxpayers would be

[71] Professor Elizabeth Owens concluded that section 903 should be repealed. *See* Owens, *The Foreign Tax Credit* 83 (1961).

[72] Temp. reg. section 4.903-1(c). The regulation further stated that "a foreign charge meets the comparability requirement unless it is reasonably clear that foreign law . . . is structured so that the amount of the liability . . . will generally be significantly greater over a reasonable period of time."

[73] *See* Karen Nelson Moore, "The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal," 7 *Am. J. Tax Pol'y* 207, 236-241 (1988); *see also* Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 *Tax L. Rev.* 227, 280 (1984).

[74] The statute and legislative history contain no mention of a comparability requirement, thus seeming to make it difficult for one to be implemented by regulation.

[75] *Biddle v. Commissioner*, 302 U.S. 573 (1938).

[76] *See* reg. section 1.901-2(a)(1)(ii) (1983).

[77] *See* articles 14 and 33 of the Taiwanese Income Tax Act.

[78] *See supra* note 58.

[79] Prop. reg. section 1.901-2(b) (Nov. 22, 2022).

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disallowed. Where the items are not themselves separate levies but are just a part of computing broader net income, the measure of how much credit is disallowed is not that difficult. A "within and without" measurement would suffice.[80] If a country disallows a deduction of $100, the foreign tax credit disallowance would be measured by the amount of reduced foreign tax that would have been paid had the deduction been allowed.

This rifle shot approach could specifically be applied to rent, royalty, and services deduction disallowances that apply to unrelated as well as related-party transactions and effectively convert a net income tax into a tax on revenues for those items of expense. It need not taint the entire income tax as applied to all taxpayers or even the remaining income tax of affected taxpayers, but only the specific tax amounts resulting from the disallowances.

Thus, from a U.S. perspective, the proposal has three parts: First, based on achieving an Inclusive Framework and/or United Nations consensus, legislation adopting an Article 12B approach to our taxation and foreign tax credit for nonresident royalty and services income applied on a reciprocal basis; second, legislation excluding from section 903 withholding taxes on rents, royalties, and services that do not include an Article 12B net income election; and third, legislation permitting the IRS and Treasury to deny credits for foreign taxes where deduction disallowances and limitations are applied to both related- and unrelated-party transactions in a manner that effectively creates a gross basis tax on an item of nonresident royalty or services income.

Of course, this package of proposals is based on the IF or other multinational forum agreeing on feasible net income formulas. I am hopeful that agreement can ultimately be reached. And if, in the meantime, we could delay implementation of the 2022 Final Regulations, and other countries could delay imposition of DSTs and any expansion of services and royalty withholding taxes, we will have accomplished something of benefit in both the short and long run. ■

[80] *See* New York State Bar Association Tax Section, "Report on Issues Relating to the Definition of a Creditable Tax for Purposes of Sections 901 and 903 of the Code" (Nov. 24, 2015).

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