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DOES CUSTOMARY INTERNATIONAL TAX LAW EXIST? A COMMENT ON "The Single Tax Principle: Fiction or Reality in a Non-Comprehensive International Tax Regime?"

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ABSTRACT

This essay responds to the excellent article, "The Single Tax Principle: Fiction or Reality in a Non-Comprehensive International Tax Regime?". In general, I agree with the author's conclusions about the incomplete nature of the adoption of the single tax principle. However, I would like to add some observations regarding the conclusion that "the international tax regime does not rise to the level of customary international law." While this may be true for the ITR as a whole, I believe there are parts of the ITR that do rise to the level of customary international law, i.e., law that "results from a general and consistent practice of states followed by them from a sense of legal obligation." "International agreements create law for states parties thereto and may lead to the creation of customary international law when such agreements are intended for adherence by states generally and are in fact widely accepted." Does customary international law (CIL) exist in tax? There are over 3,000 bilateral tax treaties, and they are about 80% identical to each other, but do they create CIL that binds in the absence of a binding treaty, like for example the Vienna Convention on the Law of Treaties binds the US, which has not ratified it? This essay will argue that the answer is yes, using four examples: jurisdiction to tax, the permanent establishment (PE) threshold, the arm's length standard, and non-discrimination.

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1. Introduction

This essay responds to the excellent article, "The Single Tax Principle: Fiction or Reality in a Non-Comprehensive International Tax Regime?".[2] In general, I agree with the author's conclusions about the incomplete nature of the adoption of the single tax principle.[3] However, I have some observations regarding the conclusion that "the international tax regime does not rise to the level of customary international law."[4] While this may be true for the international tax regime (ITR) as a whole, I believe there are parts of the ITR that do rise to the level of customary international law, and that this fact has legal implications in the absence of treaties.[5] Specifically, I will argue that the behaviour of the US and the UK in certain cases in which they were not bound by treaties (or were able to override the treaties as a matter of domestic law) indicates that they were following parts of the ITR out of a sense of legal obligation to do so.

Customary international law is law that "results from a general and consistent practice of states followed by them from a sense of legal obligation."[6] "International

[2] [Cite article].

[3] The Single Tax Principle, supra.

[4] Ibid, abstract; see section 3.3.

[5] This argument is congruent with the excellent recent paper by Irma Johanna Mosquera, BEPS Principal Purpose Test and Customary International Law (April, 2019).

[6] Rest. 3rd (For. Rel.) sec. 102(2). For other definitions see, e.g., The International Law Association (ILA) definition: a "rule of customary international law is one which is created and sustained by the constant and uniform practice of States and other subjects of international law in or impinging upon their international legal relations, in circumstances which give rise to a legitimate expectation of similar conduct in the future". International Law Association (ILA) London Conference Statement of Principles Applicable to the Formation of General Customary International Law (2000). The UN International Law Commission states that "determining a rule of customary international law requires establishing the existence of two constituent elements: a general practice, and acceptance as law (*opinio juris*)". Draft conclusions on identification of customary international law, with commentaries, adopted by the International Law Commission of the United Nations at 124. The Report will appear in the Yearbook of the International Law Commission 2018, vol. II, Part. Two. http://legal.un.org/ilc/texts/instruments/english/commentaries/1_13_2018.pdf. However, such an approach has not gone uncontested. See, for instance, the ILA, that considers that "it is not usually necessary to demonstrate the existence of the subjective element before a customary rule can be said to have come into being". For the ILA, the main point is that "it is not necessary for an individual state to have consented (still less, to be proved to have consented) to a rule for it to be bound,

agreements create law for states parties thereto and may lead to the creation of customary international law when such agreements are intended for adherence by states generally and are in fact widely accepted."[7] Does customary international law (CIL) exist in tax? There are over 3,000 bilateral tax treaties, and they are about 80% identical to each other,[8] but do they create CIL that binds in the absence of a binding treaty, like for example the Vienna Convention on the Law of Treaties binds the US, which has not ratified it? This article will argue that the answer is sometimes yes, using four examples: jurisdiction to tax, the permanent establishment (PE) threshold, the arm's length standard (ALS) and non-discrimination.

2. Jurisdiction to Tax.

There are two widely accepted bases of jurisdiction to tax: residence and source, which are the tax law equivalents of nationality and territoriality, the two bases of jurisdiction in international law. For a country to have the right to tax income, that income must either belong to a resident, since residents may be taxed on world-wide income, or it must have a source in the taxing country, since a country may tax non-residents on income sourced within it. See, for example, Internal Revenue Code (IRC) sections 1 and 11 (imposing world-wide taxation on US resident individuals and corporations) and IRC sections 2(d) and 11(b) (limiting such taxation to US-source income for non-resident individuals and corporations respectively).

The problem with these limits on jurisdiction to tax is that a resident can easily form a non-resident corporation and earn foreign source income through that corporation, which means that the income is not subject to current tax since it is neither income of a resident nor from a domestic source. This problem is particularly acute for a country like the US, which (a) defines residence of corporations mechanically by reference to place of incorporation, (b) allows taxpayers to choose which foreign entities are recognized as corporations, and (c) generally respects the separate status of corporations and shareholders.

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provided the other conditions in Part II are satisfied ." ILA 2000 at 10. For a general discussion see Mosquera, supra.

[7] Rest. 3rd (For. Rel.) sec. 102(3). Customary international law has been subjected to significant criticism. See, e.g., Joel Trachtman, The Obsolescence of Customary International Law (2014). However, most of Trachtman's critiques are based on comparing CIL to multilateral treaties, and this criticism seems not to apply to CIL in tax law, since it is almost entirely based on treaties. The key issue is whether the rules that are found in the tax treaties can bind countries that are not parties to these treaties. As long as this argument can persuade courts, CIL in tax law will exist, regardless of the theoretical debates surrounding its nature and provenance.

[8] Ash, Elliott and Marian, Omri Y., The Making of International Tax Law: Empirical Evidence from Natural Language Processing (January 11, 2019). UC Irvine School of Law Research Paper No. 2019-02. Available at SSRN: https://ssrn.com/abstract=3314310.

In the 1930s, this state of affairs led the US to consider whether it could tax a foreign corporation controlled by US residents on foreign source income. At the time, there were very few tax treaties, so the jurisdictional limit was not treaty based (and in addition, under the US Constitution Congress can override treaties). Nevertheless, the US chose not to challenge the jurisdictional limit, suggesting that it regarded itself bound by it because most countries practiced it out of a sense of legal obligation. The fact that the foreign corporation was controlled by a US resident meant that the US could have collected any tax imposed on the foreign corporation by putting a lien on the controlling shareholders' assets, so the issue was not a practical limit but a legal one.

The context was a series of Congressional hearings that revealed that rich Americans were using "incorporated pocketbooks" offshore to avoid US tax on their income. For example, Jacob Schick, the inventor of the Schick disposable razor, transferred his patent to it to a Bermuda corporation that accumulated the royalties; Schick later proceeded to retire to Bermuda, gave up his US citizenship, and lived on the accumulated tax-free profits.

To address this problem, the US adopted in 1937 a rule that taxed shareholders in "foreign personal holding corporations" (FPHCs). A FPHC was defined as a foreign corporation controlled (over 50% by vote) by five or fewer U.S. resident individuals, and whose income was over 60% passive (since passive income was considered easier to shift than active income). At the same time, the US adopted a similar rule for "personal holding corporations" (PHCs). A PHC was defined identically to the FPHC, but was a domestic corporation (at the time, like today, it was advantageous for the rich to earn passive income through PHCs because the corporate rate was about half the top individual rate).

Why were there two different rules, one for PHCs and the other for FPHCs? The only difference was that PHCs were domestic (resident) and FPHCs were foreign (non-resident). The reason can be seen in the taxing mechanism: PHCs were taxed at the corporate level at the top individual rate, but FPHCs were not taxed at all. Instead, the US taxed the US shareholders on a deemed dividend of the accumulated passive income of the FPHC. The reason was that the US considered it a breach of international law to tax a non-resident on foreign source income, since there was neither residence nor source jurisdiction. And since there was no controlling treaty, the international law involved had to be CIL.

The deemed dividend rule was upheld by Judge Frank of the Second Circuit without paying any attention to its international law implications.[9] And yet, it clearly represented a major expansion of US residence taxing jurisdiction, since taxing a

[9] Eder v. Commissioner, 138 F.2d 27 (1943). Although, of course, even if he had paid attention, he would have upheld it, since Congress can override CIL as well as treaties by legislation.

deemed dividend is economically equivalent to taxing a foreign corporation directly on foreign source income. It could certainly be argued in 1943 that this rule was a breach of international law, just like Judge Hand's *Alcoa* decision (1945), which invented the effects doctrine, was likewise arguably a breach of international law.

The impact of the deemed dividend rule was greatly expanded when the Kennedy administration decided in 1961 to propose applying the same rule to all income of corporations that are over 50% controlled by large (10% by vote each) US shareholders, i.e., to subsidiaries of US multinationals (CFCs). Ultimately, this resulted in the enactment in 1962 of "Subpart F" which applied the deemed dividend rule to certain types of income (mostly passive income) of all CFCs.[10] Again, there was no international law challenge to the deemed dividend rule. Instead, other countries began to copy the CFC regime: Germany (1972), Canada (1975), Japan (1978), France (1980), the UK (1984) and others. Currently, there are over 30 countries with CFC rules, and the number is likely to increase, since every EU member state now has to have CFC rules. Thus, it would seem that the CFC concept has arguably become part of CIL, just like the expansion of territorial jurisdiction over international waters rapidly changed international law from the 1970s onward.

Even more striking is the fact that many of the countries adopting the CFC rule abandoned the deemed dividend idea, which can lead to significant difficulties in practice, in favor of direct taxation of the CFC- i.e., direct taxation of a foreign corporation on foreign source income just because it is controlled by residents. See, e.g., Sweden, France. Thus, the jurisdictional rule has been changing and no longer seems to require a deemed dividend. Indeed, the IRS itself has adopted this view, because it now believes that the PHC regime, as well as the older accumulated earnings tax regime, both apply directly to foreign corporations even though their effect is to tax the corporation on foreign source income. This is particularly striking for PHCs, because it was so clear in 1937 that the U.S. had no jurisdiction to tax foreign corporations on foreign source income that Congress did not bother to specify that a PHC could not be a foreign corporation (while at the same time adopting the parallel FPHC regime explicitly for foreign corporations). Now this oversight enables the IRS to argue that under the new understanding of jurisdictional limits, the PHC rules apply to foreign corporations.

Claiming that nationality jurisdiction applies to foreign corporations just because they are controlled by nationals is a striking departure from ordinary international law. Compare, for example, the oft recurring disputes about the extraterritorial application of international sanctions. In both the *Fruehauf* (1965) and *Sensor* (1982) cases, the foreign courts explicitly rejected U.S. claims to require foreign subsidiaries of US multinationals to obey US sanctions aimed at China and the USSR,

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[10] IRC sections 951-960. The deemed dividend rule is still with us, since it was used as the basis of GILTI.

respectively. In *Sensor*, the Dutch court went through all the possible grounds for jurisdiction and explicitly found that none applied. It was clear that nationality jurisdiction did not apply even though the subsidiary was controlled from the United States.

What, then, enables the United States and other countries to expand nationality jurisdiction to subsidiaries in the tax area? The explanation is the "first bite at the apple rule", adopted by the League of Nations in 1923. Under that rule, the source (territorial) jurisdiction has the primary right to tax income arising within it, and the residence (nationality) jurisdiction is obligated to prevent double taxation by granting an exemption or a credit. Thus, permitting the expansion of residence jurisdiction to CFCs does not harm the right of source jurisdictions to tax them first; residence (nationality) jurisdiction only applies as a residual matter when the source jurisdiction abstains from taxing. This still leads sometimes to complaints by source jurisdictions that the residence jurisdiction is taking away their right to effectively grant tax holidays to foreign investors.

In general, I believe that this episode is a good illustration of the existence and growth of CIL in the tax area. In the 1930-1960s period, there was a clear rule of CIL that prohibited taxing foreign corporations on foreign source income. That rule was universally observed and was considered binding, as illustrated by the US avoiding an outright breach through the deemed dividend mechanism. However, once a lot of countries changed the rule by taxing CFCs directly, the US did not consider it binding any more, as indicated by applying the PHC regime to foreign corporations.

3. The PE Threshold.

The PE threshold is included in all the tax treaties: A source country may not tax business profits unless the non-resident corporation earning these profits has a PE in the source state. The PE rule stems from 19th century treaties, was included in the first models drafted by the League of Nations in the 1920s, and is found in almost every tax treaty negotiated since then. But is it CIL, i.e., does it bind countries in the absence of a treaty?

The core of the PE rule is the requirement of a physical presence, either directly (e.g., an office or a factory or employees) or through a dependent agent. Interestingly, the physical presence requirement is also found in US tax law in non-treaty situations. For example, in the *Piedras Negras* case from 1942 (i.e., long before there was a treaty between the US and Mexico), a radio station broadcasting in English from Mexico into Texas and deriving advertising revenue from Texas was held not to have a US trade or business (the IRC equivalent for PE) because it had no physical presence in the US.[11] But this rule is not derived from CIL, it is a purely domestic US requirement. Could the US abandon it without offending CIL?[12]

I think the answer is no, and that this is evidenced by the recent behavior of the UK in the digital economy context. The basic problem of the PE rule is that it is hopelessly obsolete in the 21st century, because multinationals can earn billions from a taxing jurisdiction without having any assets, employees, or even direct sales there (Facebook does not have any of these traditional items, it just has users). This is why there is a growing consensus that the PE threshold must be abandoned in favor of something else, like the EU proposal for a "substantial digital presence." The OECD has recently set out three options for reform in a consultation document, and they all abandon the PE threshold.

But what are countries to do in the meantime if they wish to tax the digital giants, and the PE threshold is included in their treaties? The interesting answer comes from the UK, the first country to adopt a "Google tax." The UK "diverted profits tax" (DPT) became effective on April 1, 2015 (i.e., before the OECD finalized the BEPS project that was supposed to solve this problem).[13] The DPT is intended primarily to address structures like Google's Double Irish Dutch Sandwich, which is contained in the guidance published by HMRC as Example 3.

Under Example 3, the US parent of a multinational group (company A) owns a subsidiary incorporated in Ireland that is treated under Irish law as resident in a tax haven (company D) which owns the IP for the rest of the world. Company D licenses the IP to Company C in the Netherlands, which in turn licenses it to Company B in Ireland. Company B owns Company E which provides sales and service support in the UK, with all sales contracts being finalized by Company B in Ireland.

Under this structure, UK tax is only applied to the cost plus profits of company E, which are minimal. Companies B, C and D do not have a PE in the UK and are not subject to tax. Company B is taxable in Ireland, but most of its profits are payable as a royalty to Company C, which it turn pays most of its profits to Company D in the tax haven. There is no withholding tax on the payment from Company B to C (because of the Ireland- Netherlands tax treaty ans the EU directives) or from C to D (because the Netherlands does not tax outbound royalties). The U.S. CFC rules (pre-TCJA) do not apply because other than Company D, all the other entities in the group

[11] COMMISSIONER OF INTERNAL REV. v. PIEDRAS NEGRAS BROADCASTING CO., 127 F.2d 260 (5th Cir., 1942).

[12] As a constitutional matter Congress could enact any rule it wanted, because it can override CIL just like it can override treaties; the question is whether it would be overriding CIL and not just treaties if it abolished the physical presence requirement.

[13] 3 FA 2015, sections 80, 81, 86.4 HMRC, Diverted Profits Tax: Interim Guidance (March 2015), 37.

are disregarded under check the box, and their activities attributed to Company D (regarded under the US rules as resident in Ireland).

The DPT subjects this arrangement to UK tax because Company B's affairs are arranged so as to avoid a UK PE. The section 86 charge will apply where there is a non-UK resident company (Company B) that is carrying on a trade; a UK resident (Company E, the "avoided PE") that is carrying on activities in the UK in connection with the supply of goods or services by Company B; it is reasonable to assume that the activity of Company E or Company B was designed to avoid Company B being subject to UK CIT; there is a "tax mismatch" in that the tax paid by Company B in Ireland is less than 80% of the tax avoided by Company E ; and tax reduction was one of the main purposes of the arrangement.

If these conditions are satisfied, a 25% DPT applies to the diverted profits (i.e., the profits that would have been taxable to Company B in the UK had it had a PE), measured initially as 30% of the deductions taken by Company B, with later adjustments (and credits for any foreign tax).

The important point to realize is that the UK could have just overridden the PE threshold and taxed Company B directly, because in the UK like other common law jurisdictions (e.g., Australia) treaties are not self executing: They have to be implemented by an Act of Parliament, and that means that they can be overridden by a later Act of Parliament. But the UK government clearly felt itself bound by the PE threshold, or else it would not have devised such a complicated new tax that is not subject to the treaties (because it is not an income tax) and therefore not subject to CIL either (since CIL in this case stems from the treaties). This suggests that the PE threshold is in fact CIL.[14]

4. The ALS.

The ALS was invented by Mitchell Carroll in the 1930s and is now incorporated into articles 7 and 9 of all the treaties.[15] It states that in establishing the profit allocation between related parties (parent and subsidiary, or head office and branch) the proper standard is to treat the parties as if they were dealing with each other at arm's length.

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[14] It should be noted, however, that Australia, which also has the power to override treaties, chose to avoid the PE threshold by enacting in 2015 an anti-avoidance rule in the income tax. Australia argued that this was not a violation of the treaties because it was an anti-abuse measure (it amends Australia's GAAR). India and other countries enacted non-income "equalization levies," but that was presumably done to avoid the treaties, not CIL, especially since some of the enacting countries (e.g., Spain) are civil law countries in which treaties are superior to domestic law.
[15] But see the 1933 League of Nations draft model tax treaty, which envisaged formulary apportionment as an alternative to ALS in the PE context.

It has long been argued that the ALS is CIL.[16] What is hard to prove is that countries consider themselves bound by the ALS in the absence of a treaty, because the ALS is the most common element in all the treaties.[17] But a recent US case is a good example.

Altera involved a cost sharing agreement between Altera, Inc. and its Cayman Islands subsidiary, and the US does not have a tax treaty with the Cayman Islands. The issue in *Altera* was whether the pool of costs that are covered by the cost sharing agreement must include the cost of stock options, even though there was overwhelming evidence that unrelated parties dealing at arm's length would not have shared those costs. The IRS had previously litigated and lost the same issue in *Xilinx,* which involved a cost sharing agreement with Xilinx's subsidiary in Ireland, so that the US-Ireland tax treaty applied. Thus, when confronted with *Xilinx*, Treasury could have distinguished it as a treaty case and amended the 1.482-7 cost sharing regulation any way it wanted for non-treaty cases. Specifically, Treasury could have relied on the legislative history of the commensurate with income standard of IRC 482. Congress stated for a cost-sharing agreement to satisfy the commensurate with income requirement, "the income allocated among the parties" should "reasonably reflect the actual economic activity undertaken by each," meaning that "the cost-sharer would be expected to bear its portion of **all** research and development costs."[18]

Moreover, Congress also stated that this result should govern **regardless of what unrelated parties would have done at arm's length**, stating that Treasury would not be required to focus on "industry norms or other unrelated party transactions" if they would not exist in a particular context (like "related party intangibles transfers"). H.R. Rep. No. 99-426, at 425 (1985). Congress explained that such transactions rarely if ever occur between unrelated parties:

A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties…. The problems are particularly acute in the case of transfers of high-profit potential intangibles…. Industry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases. Transfers between related parties do not involve the same risks as transfers to unrelated parties.[19]

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[16] Chantal Thomas, Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method, 14 BERKELEY J. INT'L L. 99 (1996); Brian Lepard, Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm's Length Standard as a Case Study, 10 Duke J. Comp. Int'l L. 43 (1999).
[17] Marian and Nash, supra.
[18] H.R. Rep. No. 99-841, at II-638 (1986) (Conf. Rep., emphasis added).
[19] Ibid.

Thus, Treasury could have just stated that the inclusion of the cost of stock options in the cost sharing pool between related parties is an exception to the ALS because there are no realistic comparables and precisely because unrelated parties would not have agreed to share of cost of stock options since the value of the options depends on the performance of an entity that by definition they do not control (i.e., an unrelated party). The *Xilinx* outcome, after all, warned the Treasury that not to address the ALS risks losing the case. Instead, Treasury in a non-treaty context, in which it was not bound by the ALS (which is for domestic law purposes only a regulatory requirement, since it is not in IRC section 482), chose to stick with the ALS and risk the consequences.

The strong implication is that Treasury believes itself bound by the ALS even when there is no formal treaty-based or statutory requirement to be so bound (i.e., where there is no treaty), and that is the essence of *opinio juris*. Thus, I believe Treasury's behavior indicates that it believes the ALS is part of CIL, and hence that CIL exists.

5. **Non-Discrimination.**

The prohibition against discrimination is included in all the tax treaties (article 24). Is it CIL?

The behavior of the US in two episodes suggests that the US believes it is. The first is the enactment of the original IRC section 163(j) in 1989. The purpose of this section was to limit the deductibility of interest paid to foreign related parties, but the US decided to apply it to "tax-exempt related parties", even though no US tax exempt ever owns over 50% in the stock of a for profit corporation (or else it would be subject to UBIT). The US could have made 163(j) a treaty override, but its behavior suggests that it was reluctant to flaunt the non-discrimination norm by explicitly applying 163(j) only to foreign related parties. This suggests that non-discrimination is CIL.

The second is the enactment of the BEAT in 2017. The BEAT explicitly only applies to foreign related parties. As a result it arguably violates non-discrimination, although in my opinion, it is not actually discriminatory because it also applies to payments from US parents to CFCs.[20] Importantly, there is no indication in the legislative history that the BEAT was intended to override treaties. This opened the door to some commentators to argue that the BEAT is in fact subject to non-discrimination, and that it should not apply in the treaty context.[21] The reluctance of

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[20] Arguably, though, it violates article 24(4), because it denies a deduction for payments to a foreign related party that is fully deductible when paid to a domestic related party. Still, it can be argued that formally the BEAT does not deny any deductions (its an alternative minimum tax on a redefined tax base).

[21] See Rosenbloom, H. David and Shaheen, Fadi, The BEAT and the Treaties (August 1, 2018). Tax Notes International, Vol. 92, No. 1, 2018. Available at SSRN: https://ssrn.com/abstract=3229532 or http://dx.doi.org/10.2139/ssrn.3229

the US to state that it was overriding article 24 suggests that it believes non-discrimination to be CIL. It was even suggested in the Congressional hearing that the BEAT is a non-income tax, similarly to the UK behavior in the DPT episode, and this likewise suggests a reluctance to appear to violate non-discrimination when there is no treaty bar from doing so (since the treaties can be overridden).

6. Conclusion: What Difference Does It Make?

I believe that the above episodes are sufficient to prove that CIL exists in some cases of international tax law. But it should also be admitted that these are relatively limited instances. Like the author of "The Single Tax Principle," I do not believe that the broader principles that in my opinion underlie the international tax regime (ITR), namely the benefits and single tax principles, are CIL, because they are violated too frequently in practice. Even the prohibition against double taxation that motivated the establishment of the ITR is frequently violated.[22]

Does the existence of CIL in tax law make a practical difference? After all, in the United States, CIL as well as treaties can be overridden by Congress through unilateral legislation, and perhaps even by Treasury through administrative action. As the Supreme Court stated in 1900:

> International law is part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction as often as questions of right depending upon it are duly presented for their determination. For this purpose, **where there is no treaty and no controlling executive or legislative act or judicial decision**, resort must be had to the customs and usages of civilized nations...[23]

But there are three situations in which CIL is nevertheless relevant as a practical matter: In countries where international law is superior to domestic law, or in international tribunals; in cases where there is no Federal law or binding treaty; and in state law.

a. Outside the US.

532; Wells, Bret and Avi-Yonah, Reuven S., The Beat and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen (August 16, 2018). U of Houston Law Center Research Paper; Tax Notes International, October 22, 2018, p. 383; U of Michigan Law & Econ Research Paper No. 18-019; U of Houston Law Center No. 2018-A10; U of Michigan Public Law Research Paper No. 617. Available at SSRN: https://ssrn.com/abstract=3232974 or http://dx.doi.org/10.2139/ssrn.3232974.

[22] See the debate about whether the human rights treaties are CIL, since they are almost universally both ratified and violated in practice.

[23] The Paquete Habana, 175 U.S. 677, 700 (1900) (emphasis added).

Outside the US, international law may be treated as superior to domestic law. This is certainly true of treaties (the VCLT explicitly rejects treaty overrides, and it is generally binding directly or as CIL, since almost every country other than the US has ratified it) but it can also be true of CIL. This is of particular interest to multinationals that may in some cases be able to invoke CIL in international tribunals.

The pending arbitration between Vodafone PLC, the UK and Netherlands based telecommunications giant, and the government of India is a good example. Vodafone invoked arbitration proceedings under both the India-U.K. and the India-Netherlands investment agreements to resolve its long-running tax dispute with India involving a 2007 acquisition. That dispute involves the tax treatment of capital gains from the Vodafone Group's 2007 acquisition of a majority stake in what was Hutchison Whampoa Ltd.'s call center business, Hutchison Essar. Although the transaction was effected by the sale of shares in a Caymans holding company, the Indian tax authority argued that Vodafone was required to withhold some $2 billion in capital gains tax at source. However, Vodafone argued that it had no tax liability on the transaction because the transfer of shares took place outside India.
The Indian Supreme Court decided the case in Vodafone's favor in January 2012, but shortly after, in March, the Indian government announced surprise retroactive legislative changes, explicitly stating that the term "transfer" includes asset transfers undertaken indirectly through the sale of shares of legal entities. In the arbitration proceedings, Vodafone has argued that CIL governs the case and that under CIL there was no tax nexus in India, and that the retroactive tax amounted to an expropriation. Since the case is in an international arbitration tribunal, CIL could decide the outcome despite the contrary explicit Indian legislation.

b. US-Federal.

As the Supreme Court has stated, CIL can be applied in US courts where there is no explicit federal legislation. This is basically the taxpayer's position in *Altera*, although it is not arguing the case explicitly on CIL grounds, but rather based on the Treasury's refusal to state that the cost sharing regulations are an exception to the ALS. In my opinion this argument is misguided, because Congress overrode the ALS in this context when it amended IRC section 482 in 1986, but the court may rule otherwise. Another instance where US taxpayers could invoke CIL is in the definition of US trade or business, like in the *Piedras Negras* case (the physical presence requirement), because the term is not defined in the IRC. It is also possible to imagine a non-discrimination argument being made in the absence of a treaty on CIL grounds.

In principle this is a broad area for lawyers to cover, because it is definitely plausible to argue that all the 80% of the treaties that are identical constitute CIL and are binding in the US in the absence of a treaty, or at least an explicit contrary practice in US treaties, legislation or regulation. One intriguing possibility is the new primary purpose test (PPT), which under the OECD BEPS project and the Multilateral

Instrument (MLI) must be included in every tax treaty that is governed by the MLI (a rapidly increasing number). The PPT states that treaty based transactions can be rejected if a primary purpose of the transaction is to take advantage of the treaty. This language can also be found in the limitation of benefits (LOB) provision of some US treaties. It will certainly be possible to argue in a few years that the PPT is CIL, since most of the world accepts it, and it certainly has good US roots in the business purpose/ economic substance line of cases (see, e.g., *Aiken Industries*). Thus, it may be possible for the IRS one day to argue that a transaction that passes technical muster under the LOB of a treaty should nevertheless be rejected under the PPT even though the treaty does not contain the PPT language. Of course, the taxpayer will argue that the LOB overrides CIL and that the US has rejected the PPT.[24] It will be an interesting case.

c. US-State.

The most obvious example of the US relevance of CIL is in state taxation cases, because CIL is international law and equivalent to a treaty, and therefore applies to and overrides contrary state law under the Supremacy Clause of the US Constitution, despite the fact that US tax treaties generally do not apply to state taxation (except for the non-discrimination provision). This is why it has been argued that the Supreme Court was wrong in deciding *Barclays* against strong evidence that the ALS was CIL, and that the Clinton administration was on good legal grounds in persuading the states not to apply formulary apportionment outside the US despite their victories in *Container* and *Barclays*.[25] All of the areas of CIL mentioned above (jurisdiction, PE, and the ALS) could in principle be invoked against the states.

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[24] The question is whether the US is a "persistent objector" to the PPT. For state practice to exists, a specific State should not have persistent and openly dissented from the rule, since in this case, such state will not be bound by the customary law rule. This is called the 'persistent objector rule' in ICJ case law. See, e.g., the Fisheries case (ICJ 1951). Accordingly, any state can, by its persistent objection, prevent an emerging rule of customary law. However, the persistent objector rule "applies only when the customary rule is in the process of emerging. It does not, therefore, benefit States which came into existence only after the rule matured, or which became involved in the activity in question only at a later stage". ICJ, Asylum case. Nevertheless, there is still uncertainty in scholarship how the persistent objector rule is applied by the ICJ. See Patrick Dumberry, 'Incoherent and Ineffective: The Concept of Persistent Objector Revisited', (2010) 59(3) ICLQ 779 – 802;Olufemi Elias, Some Remarks on the Persistent Objector Rule in Customary International Law, 6 Denning L.J. 37 (1991).

[25] Thomas, supra.