# BACKGROUND AND ANALYSIS OF THE TAXATION OF MULTINATIONAL ENTERPRISES AND THE POTENTIAL REALLOCATION OF TAXING RIGHTS UNDER THE OECD'S PILLAR ONE

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# INTRODUCTION

The House Ways and Means Committee has scheduled a public hearing for March 7, 2024, titled, "OECD Pillar 1: Ensuring the Biden Administration Puts Americans First." This document,[1] prepared by the staff of the Joint Committee on Taxation, describes legal and economic background relating to the taxation of income earned by multinational enterprises and the potential economic and revenue effects of Pillar One Amount A.

Part I includes an overview of select issues of U.S. taxation of cross-border activity. Subpart A is a general overview of the U.S. tax principles common to inbound and outbound taxation, subpart B describes U.S. tax rules applicable to foreign activities of U.S. persons, subpart C describes U.S. tax rules applicable to foreign persons, subpart D describes special measures to address potential tax avoidance, and subpart E describes how issues relating to overlapping or conflicting jurisdiction to tax are resolved.

Part II describes international efforts (lead in part by the Organisation of Economic Co-operation and Development ("OECD") at the direction of the G-20) to agree on a new means of allocating certain income of multinational enterprises and to coordinate the implementation of a global minimum tax.

Part III provides an analysis of recent economic literature that discuss the implications of cross-border taxation and Pillar One.

Part IV provides an analysis of the potential economic and revenue effects of the new means of allocating taxing rights with respect to certain income of multinational enterprises as outlined by the OECD's draft "Multilateral Convention to Implement Amount A of Pillar One."

[1] This document may be cited as follows: Joint Committee on Taxation, *Background and Analysis of the Taxation of Multinational Enterprises and the Potential Reallocation of Taxing Rights under the OECD's Pillar One* (JCX-7-24), March 5, 2024. This document can be found on the Joint Committee on Taxation website at www.jct.gov. Unless otherwise indicated, all section references in this document are to the Internal Revenue Code of 1986, as amended (the "Code").

# I. OVERVIEW OF SELECT ISSUES OF U.S. TAXATION OF CROSS-BORDER ACTIVITY

The following discussion summarizes U.S. taxation of income from cross-border business activity, with emphasis on how the rules determine whether the income is subject to tax by the United States or another jurisdiction in either the Code or in bilateral agreements in which the United States agrees to relieve double taxation when its jurisdiction to tax overlaps or is in conflict with that of another jurisdiction.

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct and persons (whether natural or juridical) with a sufficient nexus to the sovereign nation. The nexus may be based on nationality (*i.e.*, a nexus based on a connection between the relevant person and the sovereign nation) or may be territorial (*i.e.*, a nexus based on a connection between the relevant conduct and the sovereign nation). These concepts have been refined and adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to tax.

## A. U.S. Tax Principles Common to Inbound and Outbound Taxation

Taxes based on where activities occur, or where property is located, are source-based taxes. The United States generally taxes the U.S. trades or businesses of foreign persons and sales or other dispositions of interests in U.S. real property by foreign persons. In addition, the United States generally taxes items of income that are paid by U.S. persons to foreign persons. Most jurisdictions, including the United States, have rules for determining the source of items of income and expense in a broad range of categories, such as compensation for services, dividends, interest, royalties, and gains.

Income taxes based on a person's citizenship, nationality, or residence are residence-based taxes. The United States generally imposes residence-based taxation on U.S. persons in the year in which income is earned. For individuals and domestic entities, this results in taxing them on their worldwide income, whether derived in the United States or abroad, with limited opportunity for deferral of taxation of income earned by foreign corporations owned by U.S. shareholders. As explained below, income earned by a resident of the United States from foreign activities conducted through a foreign entity generally is subject to U.S. tax in the year earned or not at all. The United States generally taxes foreign persons on only U.S.-source income.

The United States imposes source-based taxation on U.S.-source income of nonresident alien individuals and other foreign persons. Under this system, the application of the Code differs depending on whether income arises from outbound investment (*i.e.*, foreign investments by U.S. persons) or inbound investment (*i.e.*, U.S. investment by foreign persons). While the United States taxes inbound and outbound investments differently, certain rules are common to the taxation of both, including rules relating to residency, entity classification, source determination, and transfer pricing.

## 1. Residence

The Code defines a U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, trusts, and estates.[2] Partnerships and corporations are domestic if organized or created under the laws of the United States, any State, or the District of Columbia, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[3] All other partnerships and corporations (*i.e.*, those organized under the laws of foreign countries) are foreign.[4] Other jurisdictions may use factors such as situs or management and control to determine residence. As a result, legal entities may have more than one tax residence or, in some cases, no residence. In such cases, bilateral treaties may resolve conflicting claims of residence. In certain cases, a foreign corporation that acquires a domestic corporation or partnership may be treated as a domestic corporation for Federal tax purposes if the transaction falls within the scope of the rules relating to expatriated entities and their foreign parents.[5]

## 2. Source of income rules

Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor or recipient and the location of the activities or assets that generate the income. Extensive rules determine whether income is considered to be from U.S. sources or foreign sources.[6] Special rules are provided for certain industries, (*e.g.*, transportation, shipping, and certain space and ocean activities) as well as for income partly from within and partly from without the United States.[7]

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[2] Sec. 7701(a)(30).

[3] Sec. 7701(a)(4) and (10).

[4] Sec. 7701(a)(5) and (9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.

[5] Sec. 7874. The Treasury Department and the IRS have promulgated detailed guidance, through both regulations and several notices, addressing the requirements under section 7874 since its enactment in 2004, and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions. If the requirements are satisfied, the foreign corporation is not treated as a domestic corporation and, instead, is considered a surrogate foreign corporation for the acquired domestic company, which is an expatriated entity that must recognize certain "inversion gains" on post-acquisition restructuring. An excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Sec. 4985. In addition, dividends from certain surrogate foreign corporations are excluded from qualified dividend income within the meaning of section 1(h)(11)(B) and are ineligible to be taxed as net capital gains. Sec. 1(h)(11)(C)(iii). As a result, individual shareholders in such corporations cannot claim the reduced rate on dividends otherwise available under section 1(h)(11). Other consequences may apply as well. See secs. 59A(d)(4) (providing that payments made to expatriated entities that reduce gross receipts are base erosion payments) and 965(l) (disallowing the partial participation exemption deduction for computing the transition tax and assessing the additional transition tax in the year of inversion if an entity inverts within the 10-year period beginning on December 22, 2017).

[6] Sections 861 through 865, generally.

[7] Sec. 863.

Gains, profits, and income from the sale or exchange of inventory property that is either (1) produced (in whole or in part) inside the United States and then sold or exchanged outside the United States or (2) produced (in whole or part) outside the United States and then sold or exchanged inside the United States is allocated and apportioned solely on the basis of the location of the production activities.[8] For example, income derived from the sale of inventory produced entirely in the United States is wholly from U.S. sources, even if title passage occurs elsewhere. Likewise, income derived from the sale of inventory produced entirely in another country is wholly from foreign sources, even if title passage occurs in the United States. If inventory is produced only partly in the United States, the income derived from its sale is sourced partly in the United States regardless of where title to the property passes.

### 3. Transfer pricing

**General rule – arm's-length standard**

Section 482 authorizes the Secretary to allocate income, deductions, credits, or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance. Comprehensive Treasury regulations under that section generally adopt the arm's-length standard as the method for determining whether a particular allocation is appropriate.[9] Under that standard, the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in a similar transaction with unrelated parties bargaining at arm's length. The arm's-length standard is broadly accepted internationally, including by all members of the OECD as well as many nonmembers.[10]

**Special rules**

Intangible property

Section 482 requires that the income with respect to a transfer of intangible property be commensurate with the income attributable to the intangible. By requiring inclusion of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[11]

[8] Sec. 863(b). Prior to Public Law 115-97, enacted on December 22, 2017, the source of income from sale of inventory was determined by passage of title.

[9] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

[10] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022* ("OECD Guidelines"), OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en. The publication was approved by the OECD/G20 Inclusive Framework on BEPS on January 7, 2022.

[11] House Ways and Means Committee Report to accompany H.R. 3838, the Tax Reform Act of 1986, H.R. Rep. No. 99-426, December 7, 1985, p. 423.

A U.S. person may transfer intangible property to a related person (typically, a foreign affiliate) in one of four ways: (1) an outright transfer of the intangible property; (2) a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate; (3) the provision of a service by the U.S. person to the foreign affiliate using the intangible property, rather than a direct transfer of the property; and (4) a transfer by the U.S. person of intangible property through a qualified cost-sharing arrangement with one or more foreign affiliates, under which the participants make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable product or service. A qualified cost-sharing arrangement is an agreement between taxpayers under common control that satisfies the requirements prescribed under regulations.[12] The method of transfer may determine whether the applicable section is section 482 or section 367(d).[13]

Definition of intangible property

For purposes of section 482, intangible property is defined by reference to the provision governing gain recognition from outbound transfers of intangible property.[14] That provision includes a list of enumerated items that specifically include goodwill, going-concern value, and workforce-in-place. It also includes a residual category of "any item the value of which is not attributable to tangible property or the services of any individual." As a result, neither source nor amount of value is relevant in determining whether property in one of the other enumerated categories is within the scope of the definition.[15]

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[12] Treas. Reg. sec. 1.482-7. See also OECD Guidelines, Chapter VIII "Cost contribution arrangements."

[13] Section 367(d) requires the use of transfer pricing principles in determining gain to be recognized from a transfer within the scope of that section. In addition, special rules may apply in the case of a U.S. taxpayer's transfer of property to a partnership with related foreign partners under sections 704(c) and 721(c) and the related regulations thereunder.

[14] Sec. 367(d)(4). The definition of intangible property was formerly in section 936(h)(3)(B), as amended by section 14221 of Public Law 115-97. That operative definition of intangible property was moved to section 367(d) as a conforming amendment to the repeal of section 936 as deadwood, in the Consolidated Appropriations Act, 2018. See Pub. L. No. 115-141, Division U, Title IV, at sec. 401(d)(1)(C) (the repeal of section 936) and sec. 401(d)(1)(D)(viii)(I) (definition of intangible property added to section 367(d)) (March 23, 2018).

[15] Prior to amendment, section 936(h)(3)(B) read as follows: The term "intangible property" means any -- (i) patent, invention, formula, process, design, pattern or know-how; (ii) copyright and literary, musical or artistic composition; (iii) trademark, trade name or brand name; (iv) franchise, license or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or (vi) any similar item, which has substantial value independent of any individual. Despite consensus around the use of arm's-length standard and extensive guidance, questions surrounding the difficulties posed by intercompany pricing requirements were raised, including recurring definitional and methodological issues and concerns about use of aggressive transfer pricing. See, *e.g.*, *Veritas Software Corp. v. Commissioner,* 133 T.C. 297 (Dec. 10, 2009) (including goodwill and going concern value within the definition would "expand" the regulatory definition in effect for the tax year before the Court), *non-acq*., AOD-2010-05, I.R.B. No. 2010-49 (Dec. 6, 2010); *Medtronic Inc. & Consolidated Subs. v. Commissioner*, T.C. Memo. 2016-112 (accepting taxpayer use of the comparable uncontrolled transaction method with few adjustments), vacated and remanded 900 F.3d 610 (8th Cir. 2018) (further findings required to evaluate whether the methodology accepted by the Tax Court was the best method), T.C. Memo. 2022-84 (adopting

Valuation of intangibles

Section 482 provides that "[f]or purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers."[16] The mandated use of the aggregate basis valuation method in these cases under section 482 is consistent with regulations promulgated prior to the 2017 revision of the statute, which required that synergies created by the interrelated nature of intangible assets that are transferred in one or more contemporaneous transactions be properly taken into account in order to reach an arm's-length result.[17] The approach is also consistent with Tax Court's decisions in cases outside of the section 482 context, in which collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate,[18] as well as existing cost-sharing regulations.[19] Similarly, the realistic alternative principle is consistent with regulations[20] that pre-date inclusion in the statutory language, and is

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an unspecified method to determine pricing); and *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8 (2017), *aff'd* 934 F.3d 976 (9th Cir. 2019) (holding that "workforce in place, going concern value, goodwill, and what trial witnesses described as 'growth options' and corporate 'resources' or 'opportunities'" all fell outside the definition under prior law). See also Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010; OECD, *Addressing Base Erosion and Profit Shifting*, 2013, available at https://www.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en (last accessed July 12, 2023); OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*, October 5, 2015. The findings of the OECD report in 2015 resulted in further guidance that has since been incorporated in the OECD Guidelines.

[16] Sec. 482. A contemporaneous expansion of the regulatory authority under section 367 makes clear that the IRS may require the use of aggregate basis valuation and apply the realistic alternative principle in valuation of intangibles transferred in outbound restructuring of U.S. operations.

[17] See Treas. Reg. secs. 1.482-1(f)(2), 1.482-4(c)(1); Treas. Reg. sec. 1.482-1T, which sunset September 14, 2018.

[18] See, *e.g.*, *Kraft Foods Co. v. Commissioner*, 21 T.C. 513 (1954) (determining that 31 related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Commissioner*, 25 B.T.A. 281, p. 283 (1932) (finding that "it is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); and *Massey-Ferguson, Inc. v. Commissioner*, 59 T.C. 220 (1972) (holding that the taxpayer, who abandoned a distribution network of contracts with separate distributorships, was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).

[19] See Treas. Reg. sec. 1.482-7(g)(2)(iv) (providing that if multiple transactions in connection with a cost-sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's-length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).

[20] See Treas. Reg. sec. 1.482-7(g)(2)(iii) and Examples (1), (2) and (3), thereunder.

predicated on the notion that a taxpayer enters into a particular transaction only if none of its realistic alternatives is economically preferable to the transaction under consideration.

## B. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons

In general, income earned directly by a U.S. person from the conduct of a foreign trade or business is taxed currently,[21] while income earned indirectly through certain related foreign entities (*i.e.*, controlled foreign corporations ("CFCs"))[22] is taxed in the year earned or not at all.[23] Earnings and profits of CFCs are generally taxable in one of two ways. First, the earnings may constitute income to U.S. shareholders under the traditional anti-deferral regime of subpart F, which applies to certain passive income and income that is readily movable from one jurisdiction to another.[24] Subpart F was designed as an anti-abuse regime to prevent U.S. taxpayers from shifting passive and mobile income to low-tax jurisdictions.[25] Second, the earnings may be subject to section 951A, which applies to some foreign-source income of a CFC that is not subpart F income. Such income is referred to as global intangible low-taxed income ("GILTI"). GILTI was enacted as a base protection measure to counter the participation exemption system, established by the dividends-received-deduction, under which the income could potentially be distributed back to the U.S. corporation with no U.S. tax imposed.[26] Subpart F income is taxed at full rates with related foreign taxes generally eligible for the foreign tax credit; GILTI is taxed at reduced rates with additional limitations on the use of related foreign tax credits. Both subpart F income and GILTI are included by the U.S. shareholder without regard to whether the earnings are distributed by the CFC.

In addition to the taxation of GILTI at reduced rates, U.S. corporations generally are taxed at reduced rates on their foreign-derived intangible income ("FDII").[27] Foreign earnings not subject to tax as subpart F income or GILTI generally are exempt from U.S. tax. To exempt those earnings, dividends received by corporate U.S. shareholders from specified 10-percent

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[21] Such income is called foreign branch income.

[22] A CFC generally is defined as any foreign corporation in which U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only "U.S. shareholders," that is, U.S. persons who own at least 10 percent of the stock (measured by vote or value). See secs. 951(b), 957, and 958. Special rules apply with respect to U.S. persons that are shareholders (regardless of their percentage ownership) in any foreign corporation that is not a CFC but is a passive foreign investment company ("PFIC"). See secs. 1291 through 1298. The PFIC rules generally seek to prevent the deferral of passive income through the use of foreign corporations.

[23] For a more detailed discussion of the rules, see Joint Committee on Taxation, *Background and Analysis of the Taxation of Income Earned by Multinational Enterprises* (JCX-35R-23), July 17, 2023, Part I.B. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[24] Subpart F comprises sections 951 through 965.

[25] See JCS-5-61, "Tax Effects of Conducting Foreign Business through Foreign Corporations" (July 21, 1961), Part V. See also Rev. Act. of 1962, Pub. L. No. 87-834.

[26] See Reconciliation Recommendations Pursuant to H. Con. Res. 71 (December 2017).

[27] Sec. 250(a)(1)(A).

owned foreign corporations (including CFCs) generally are eligible for a 100-percent dividends-received deduction ("DRD").[28] Special rules apply in situations in which a U.S. person transfers property to a foreign corporation or certain partnerships in certain nonrecognition transactions.[29]

## C. U.S. Tax Rules Applicable to Foreign Persons

Nonresident aliens and foreign corporations generally are subject to U.S. tax only on their U.S.-source income. There are two broad types of taxation of U.S.-source income of foreign taxpayers: (1) gross-basis tax on income that is "fixed or determinable annual or periodical gains, profits, and income" (*i.e.*, FDAP income), and (2) net-basis tax on income that is "effectively connected with the conduct of a trade or business within the United States" (*i.e.*, ECI). FDAP income, although nominally subject to a statutory 30-percent gross-basis tax withheld at its source, in many cases is subject to a reduced rate of, or entirely exempt from, U.S. tax under the Code or a bilateral income tax treaty. ECI generally is subject to the same U.S. tax rules and rates that apply to business income earned by U.S. persons.

### 1. Gross-basis taxation of U.S.-source income

FDAP income received by foreign persons from U.S. sources is subject to a 30-percent gross-basis tax (*i.e.*, a tax on gross income without reduction for related expenses), which is collected by withholding at the source of the payment. FDAP income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments.[30] The items enumerated in defining FDAP income are illustrative, and the words "annual or periodical" are "merely generally descriptive" of the payments within the purview of the statute.[31] Capital gains of nonresident aliens generally are foreign source; however, capital gains of nonresident aliens present in the United States for 183 days or more[32] during the year are income from U.S. sources subject to gross-basis taxation.[33] In addition, U.S.-source gains from the sale or exchange of intangibles are subject to tax and withholding if they are contingent on the productivity, use, or disposition of the property sold.[34] The categories of income subject

[28] Sec. 245A. The DRD is not limited to dividends from CFCs, but rather may be available with respect to any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a U.S. shareholder with respect to such foreign corporation.

[29] Secs. 367 and 721(c); Treas. Reg. sec. 1.721(c)-1.

[30] Secs. 871(a) and 881. FDAP income that is ECI is taxed as ECI.

[31] *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

[32] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

[33] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as ECI under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). See sec. 897(a)(1).

[34] Secs. 871(a)(1)(D) and 881(a)(4).

to the 30-percent tax and the categories for which withholding is required generally are coextensive.[35]

**Exclusions from FDAP income**

FDAP income encompasses a broad range of gross income but has important exceptions.

Interest on bank deposits may qualify for exemption from treatment as FDAP income on two grounds. First, interest on deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, is U.S.-source income but is exempt from the 30-percent tax when paid to a foreign person.[36] Second, interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not U.S.-source income and, thus, is not subject to U.S. tax.[37] Interest and original issue discount on certain short-term obligations also is exempt from U.S. tax when paid to a foreign person.[38] In addition, an exception to information reporting requirements may apply with respect to payments of such exempt amounts.[39]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30-percent gross-basis tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[40] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[41] certain contingent interest,[42] interest received by a CFC from a related person,[43] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[44]

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[35] See secs. 1441 and 1442.

[36] Secs. 871(i)(2)(A) and 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[37] Sec. 861(a)(1); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[38] Secs. 871(g)(1)(B) and 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[39] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A) and (B). A bank must report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and -8. The IRS publishes lists of the countries whose residents are subject to the reporting requirements, and those countries with respect to which the reported information is automatically exchanged. See Rev. Proc. 2022-35, 2022-40 I.R.B. 270.

[40] Sec. 871(h)(2).

[41] Sec. 871(h)(3). The exemption does not apply to interest payments made to a foreign lender that owns 10 percent or more of the voting power (but not value) of the stock of the borrower.

[42] Sec. 871(h)(4).

[43] Sec. 881(c)(3)(C).

[44] Sec. 881(c)(3)(A).

**Withholding of 30-percent gross-basis tax**

The 30-percent tax on FDAP income is generally collected by means of withholding.[45] Withholding on FDAP payments to foreign payees is required unless the withholding agent (*i.e.*, the person making the payment to the foreign person) can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[46]

Often, the income subject to withholding is the only income of the foreign person subject to any U.S. tax. If the foreign person has no ECI and the withholding is sufficient to satisfy the tax liability with respect to FDAP income, the foreign person generally is not required to file a U.S. Federal income tax return. Accordingly, the withholding of the 30-percent gross-basis tax generally represents the collection of the foreign person's final U.S. tax liability.

To the extent that a withholding agent withholds an amount, the withheld tax is credited to the foreign recipient of the income.[47] If the agent withholds more than is required, and that results in an overpayment of tax, the foreign recipient may file a claim for refund.

**2. Net-basis taxation of income from conduct of a trade or business within the United States**

Income that is effectively connected with the conduct of a trade or business within the United States (*i.e.*, ECI) generally is subject to tax on a net basis under the same U.S. tax rules and rates that apply to business income earned by U.S. persons.[48]

**U.S. trade or business**

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in a U.S. trade or business if the partnership, estate, or trust is so engaged.[49]

Whether a foreign person is engaged in a U.S. trade or business is a factual question that has generated a significant amount of case law. Basic issues include whether the activity rises to the level of a trade or business, whether a trade or business has sufficient connections to the United States, and whether the relationship between the foreign person and persons performing

[45] Secs. 1441 and 1442.

[46] A withholding agent includes any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a). See also Treas. Reg. sec. 1.1441-6 (providing, in part, the requirements (including documentary evidence) that must be satisfied for purposes of claiming the benefits of an exemption from or reduced rate of withholding under a treaty).

[47] Sec. 1462.

[48] Secs. 871(b) and 882.

[49] Sec. 875.

activities in the United States for the foreign person is sufficient to attribute those activities to the foreign person.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

**Effectively connected income**

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on ECI from that trade or business. Specific statutory rules govern whether income is ECI.[50]

In general, for a foreign person engaged in the conduct of a U.S. trade or business, all income, gain, or loss from sources within the United States is treated as ECI.[51]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross-basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business, and whether the activities of the U.S. trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[52] Under the asset use and business activities tests, due regard is given to whether such asset or such income, gain, deduction, or loss was accounted for through the trade or business.

A foreign person that is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[53] A foreign tax credit may be allowed

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[50] Sec. 864(c).

[51] Sec. 864(c)(3).

[52] Sec. 864(c)(2).

[53] A foreign person's income from foreign sources generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, goodwill, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange. Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income. Sec. 864(c)(4)(B) and (D)(i).

with respect to foreign income tax imposed on such income.[54] Foreign-source income not included in one of those categories generally is exempt from U.S. tax.

**Allowance of deductions**

Taxable ECI is computed by taking into account deductions associated with gross ECI. Regulations address the allocation and apportionment of deductions between ECI and other income. Certain deductions may be allocated and apportioned on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. Specific rules provide for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. In general, interest is allocated and apportioned based on assets rather than income.

**Sales of partnership interests**

Gain or loss from the sale or exchange of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.[55] Any gain or loss from such hypothetical asset sale by the partnership must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

The transferee of a partnership interest must withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the sale qualifies for an exception from withholding, *e.g.*, that the transferor is not a nonresident alien individual or foreign corporation or that there is no realized gain from the sale.[56] If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.[57]

**Foreign Investment in Real Property Act ("FIRPTA")**

A foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") is treated as ECI.[58] Thus, a foreign person subject to tax on such a disposition is required to file a U.S. tax return. In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate). Certain sales of USRPI are exempt from this tax. For example, qualified foreign pension funds are not treated as nonresident alien individuals or foreign corporations

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[54] See sec. 906.

[55] Sec. 864(c)(8)(B).

[56] Sec. 1446(f)(1).

[57] Sec. 1446(f)(4); Treas. Reg. sec. 1.1446(f)-2(b).

[58] Sec. 897(a).

subject to tax under FIRPTA,[59] foreign governments are exempt from FIRPTA tax on gain from certain sales of stock of U.S. real property holding corporations,[60] and equity interests in "domestically controlled" REITs are not USRPIs.[61]

The payor of income that FIRPTA treats as ECI is generally required to withhold U.S. tax from the payment.[62] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's overall tax liability for the taxable year.

## D. Special Measures to Address Potential Tax Avoidance

### 1. Base erosion and anti-abuse tax

The base erosion and anti-abuse tax (*i.e.*, the BEAT) is an additional tax imposed on certain multinational corporations with respect to payments to foreign affiliates.[63]

The BEAT applies only to corporate taxpayers with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year in excess of $500 million, and is determined, in part, by the extent to which a taxpayer has made payments to foreign related parties.[64] The BEAT generally does not apply to taxpayers for which reductions to taxable income ("base erosion tax benefits") arising from payments to foreign related parties ("base erosion payments") are less than three percent of total deductions (*i.e.*, a "base erosion percentage" of less than three percent).[65]

For a taxpayer subject to the BEAT (an "applicable taxpayer"), the additional tax (the "base erosion minimum tax amount" or "BEAT liability") for the year generally equals the excess, if any, of 10 percent of its modified taxable income over an amount equal to its regular tax liability reduced (but not below zero) by the sum of certain tax credits.[66]

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[59] Sec. 897(l)(1).

[60] Treas. Reg. sec. 1.892-3T(a).

[61] Sec. 897(h)(2).

[62] Sec. 1445 and regulations thereunder.

[63] Sec. 59A.

[64] For this purpose, a related party is, with respect to the taxpayer, any 25-percent owner of the taxpayer; any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer; and any other person who is related (within the meaning of section 482) to the taxpayer. Sec. 59A(g). The 25-percent ownership threshold is determined by vote or value.

[65] Sec. 59A.

[66] Sec. 59A(e). For taxable years beginning after December 31, 2025, the 10-percent rate on modified taxable income is increased to 12.5 percent, and regular tax liability is reduced (and the base erosion minimum tax amount is therefore increased) by the sum of all the taxpayer's income tax credits for the taxable year. Sec. 59A(b)(2). In addition, special rules with respect to banks and securities dealers provide that for purposes of determining whether they are subject to the BEAT, banks and securities dealers are subject to a base erosion

## 2. Branch profits taxes

The branch profits tax generally seeks to equalize the tax treatment of a dividend to a foreign person paid from a domestic branch with that paid from a domestic corporation. A domestic corporation is subject to U.S. income tax on its net income. The earnings of the domestic corporation may be subject to a second tax, this time at the shareholder level, when dividends are paid. When the shareholders are foreign, the second-level tax may be collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to withholding tax. To approximate those second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign shareholders, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted (to the head office) out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation.[67] Those branch taxes may be reduced or eliminated under an applicable income tax treaty.[68]

## 3. Hybrid arrangements

Hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve tax benefits, including double nontaxation and deferral. Special rules seek to combat the use of such arrangements. These rules include denying deductions relating to certain interest and royalty payments.[69]

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percentage threshold of two percent (rather than three percent), and if that threshold is met, such persons are subject to a tax rate on its modified taxable income that is one-percentage point higher than the generally applicable tax rate. Secs. 59A(b)(3) and 59A(e)(1)(C).

[67] Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount." Sec. 884(a). The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI. Sec. 884(b).

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore generally is subject to 30-percent withholding tax if paid to a foreign person. Sec. 884(f)(1)(A). Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, also may be subject to 30-percent withholding tax. Sec. 884(f)(1)(B). For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

[68] See Treas. Reg. secs. 1.884-1(g) and -4(b)(8).

[69] Sec. 267A; see also sec. 245A(e) (addressing hybrid dividends).

Specifically, no deduction is allowed for any "disqualified related party amount"[70] that is paid or accrued pursuant to a hybrid transaction[71] or that is paid or accrued by, or to, a hybrid entity.[72]

### E. Resolving Overlapping or Conflicting Jurisdiction to Tax

Multinational enterprises operating in multiple countries may find that the same item of income is subject to tax under the rules of two or more jurisdictions. Such double taxation may be mitigated by domestic laws permitting credit or deduction for income taxes paid to another jurisdiction or by bilateral tax treaties. Another related objective of such treaties is the removal of barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

#### 1. Relief from double taxation by statute

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed a credit or deduction for foreign income taxes they pay. In addition, a domestic corporation is allowed a credit for foreign income taxes paid by a CFC with respect to income included by the corporation as subpart F income and GILTI; such taxes are deemed to have been paid by the domestic corporation for purposes of calculating the foreign tax credit.[73]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income. The limit is intended to ensure that the credit mitigates double taxation

[70] A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or in which such related party is subject to tax, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. Sec. 267A(b)(1). A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under subpart F. In general, a related party is any person that controls, or is controlled by, the taxpayer, with control being direct or indirect ownership of more than 50 percent of the vote, value, or beneficial interests of the relevant person. Sec. 267A(b)(2).

[71] A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or in which the recipient is subject to tax. Sec. 267A(c).

[72] A hybrid entity is any entity which is either: (1) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax but not so treated for Federal income tax purposes. Sec. 267A(d).

[73] Secs. 901, 903, and 960; see also secs. 1291(g) and 1293(f) (providing, in the PFIC context, coordination with foreign tax credit rules). For any subpart F income included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to the aggregate foreign income taxes paid or accrued with respect to such income by the CFC. For any GILTI included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to 80 percent of the corporation's inclusion percentage multiplied by the aggregate foreign income taxes paid or accrued with respect to tested income (but not tested loss) by each CFC with respect to which the domestic corporation is a U.S. shareholder. Sec. 960(d)(1).

of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total pre-credit U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may (in certain cases) carry back the excess foreign taxes to the previous year and then carry forward any remaining excess to one of the 10 succeeding taxable years. No carryback or carryover of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

### 2. Bilateral treaties to relieve double taxation

The United States is a partner in numerous bilateral treaties that aim to avoid international double taxation and to prevent tax avoidance and evasion. The United States Model Income Tax Convention of 2016 ("Model Treaty") was published in 2016 and reflects the most recent comprehensive statement of U.S. policy with respect to tax treaties.[74] As explained in the Preamble published contemporaneously with the Model Treaty, the provisions therein included both refinements of provisions that have been included in U.S. tax treaties, as well as new provisions, not yet incorporated in a bilateral treaty, that deny treaty benefits on deductible payments of highly mobile income that are made to related persons that enjoy low or no taxation with respect to that income under a special tax regime.[75] To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions may modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to allocate taxing authority by limiting, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") may tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both countries. A "limitation on benefits" provision in treaties further determines whether a treaty resident is a qualified person permitted to receive treaty

[74] The Model Treaty has been updated periodically. The Model Treaty and its Preamble, as well as text of earlier Model Treaties, are available at https://home.treasury.gov/policy-issues/tax-policy/treaties.

[75] For example, the Model Treaty denies treaty benefits when U.S.-source payments are made to a beneficial owner that benefits from a special tax regime, as defined in Article 3 (General Definitions), subparagraph (l) of paragraph 1; the benefits that may be denied include the reduced withholding rates on dividends, interest, and royalties that are paid to persons that fail to satisfy the limitation on benefits requirements in Article 22 (Limitation on Benefits).

benefits. This provision limits the ability of third country residents to engage in treaty shopping by establishing conduit legal entities in either the United States or the treaty partner jurisdiction. The provision sets forth objective tests that commonly include a publicly traded company test, an ownership and base erosion test, and an active trade or business test.

Treaties generally provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction, and the business income is attributable to that permanent establishment. As explained above, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation by requiring a threshold for permanent establishment status that is higher than that required to constitute a U.S. trade or business under the Code. As a result, a foreign corporation engaged in a U.S. trade or business but not through a permanent establishment generally would not be taxable in the United States under an applicable treaty. The term "attributable to" is generally analogous to the "effectively connected" concept in section 864(c). Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount).

Treaties address the taxation of passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely)[76] in return for reciprocal treatment by its treaty partner. In particular, under the Model Treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and some recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

[76] The rates agreed upon in U.S. bilateral tax treaties for income other than personal services income are found in "Table 1. Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties (Rev. May 2023)" at https://www.irs.gov/individuals/international-taxpayers/tax-treaty-tables.

## II. OECD TWO-PILLAR SOLUTION

This section describes the current status of the OECD project undertaken at the direction of the G-20[77] to address base-erosion and profit shifting ("BEPS") concerns.[78] Although other actions taken in the BEPS project have been adopted by various jurisdictions, including the United States,[79] the OECD final report on how to address problems presented by the digital economy did not provide proposed standards or solutions.[80] Since the release of that report, many jurisdictions have taken unilateral action to target certain aspects of digital services provided in general by large technology companies headquartered in the United States, including by imposing unilateral digital services taxes ("DSTs"). At the urging of the G-20, the OECD continues to work on the project. It has proposed blueprints of two pillars as a solution[81] and has held public consultations for further development of those pillars.

In October 2021, the OECD and the G-20 announced that the Inclusive Framework had agreed in principle to the proposed two-pillar solution to address the tax challenges arising from the current state of international taxation of multinational enterprises ("MNEs"). The Statement included a moratorium on adoption or enforcement of unilateral measures. The signatories agreed that "[n]o newly enacted Digital Services Taxes or other relevant similar measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the [forthcoming Multilateral Convention on Pillar One]." [82]

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[77] In asking the OECD to develop a response to the economic challenges arising from global digitalization, the G-20 explicitly directed that non-OECD and non-G-20 members be included to ensure global consensus. The resulting body, the OECD/G-20 Inclusive Framework on BEPS (the "Inclusive Framework"), formed in 2015, now has over 140 members. A list of members may be found https://www.oecd.org/tax/beps.

[78] For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[79] Changes to U.S. law enacted in 2017 by Public Law 115-97 ameliorated certain aspects of those concerns. In particular, the introduction of GILTI and section 245A dividends-received deduction ensure that certain income previously eligible for deferral is now taxed at a minimum level in the year earned or not at all, thus ending most deferral and the "lockout" effect.

[80] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, available at http://www keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report 9789264241046-en. The concern addressed in the report is that foreign multinational companies without a physical presence in a jurisdiction could impact the local economy, earning revenues generated by the digital activity within their jurisdiction, without incurring taxation under existing international norms of taxation.

[81] OECD (2021), *Tax Challenges Arising from Digitalisation—Report on the Pillar One Blueprint* ("Pillar One Blueprint"), available at http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en.htm and *Tax Challenges Arising from Digitalisation—Report on the Pillar Two Blueprint* ("Pillar Two Blueprint"), available at http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en htm.

[82] OECD (2021), *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* ("October 2021 Statement"), OECD, Paris, https://www.oecd.org/tax/beps/statement-

In addition, the Statement included an Annex describing the planned implementation of the two pillars. Pillar One provides for the removal of unilateral measures and revises the principles governing profit allocation among related parties and the amount and kind of contact between a business and a country (*i.e.*, nexus) that is deemed sufficient to justify that country's taxation of that business. Pillar Two establishes a set of rules to enforce a minimum global level of income taxation, addressing structures used by certain MNEs that allow for the shifting of profits into jurisdictions with low or zero tax rates.

In October 2023, the OECD published a consolidated draft of a proposed Multilateral Convention on Pillar One (the "MLC"), limited to implementation of Amount A, together with two related documents.[83] In December 2023, the OECD/G20 Inclusive Framework on BEPS reaffirmed its commitment to completing the project while updating the timing of its projected completion of technical work on Pillar One by the end of March 2024, in anticipation of opening the MLC for signature by the end of June 2024.[84]

### A. Pillar One

Under the terms of the Pillar One Blueprint, as well as all subsequent iterations of the terms of Pillar One, members of the Inclusive Framework agree to rescind existing, and forgo future, DSTs and other unilateral measures in return for international consensus regarding the proper allocation of taxing rights with respect to certain profits of the largest MNEs.[85] Such allocation requires determination of the residual profit that is allocated to market jurisdictions ("Amount A") and ceding taxing rights to market jurisdictions within a framework that ensures tax certainty for the affected firms within scope of the measure. Since initial publication of the Pillar One Blueprint, the specific components of the proposal have changed with each iteration of the components in documents published by the OECD Secretariat, generally also including a feature that provides for a streamlined determination and allocation of profit from routine controlled transactions ("Amount B").

Even with the publication of the MLC in late 2023, both political and technical issues remain unresolved. For example, several large jurisdictions (including Brazil, Colombia, and

on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021 htm.

[83] The three documents published by the OECD on October 11, 2023, are *Multilateral Convention to Implement Amount A of Pillar One* ("MLC"), available at https://www.oecd.org/tax/beps/multilateral-convention-to-implement-amount-a-of-pillar-one.pdf; *Explanatory Statement to the Multilateral Convention to Implement Amount A of Pillar One,* available at https://www.oecd.org/tax/beps/explanatory-statement-multilateral-convention-to-implement-amount-a-of-pillar-one.pdf; and *Understanding on the Application of Certainty for Amount A of Pillar One* ("Tax Certainty Understanding"), available at https://www.oecd.org/tax/beps/understanding-on-the-application-of-certainty-for-amount-a-of-pillar-one.pdf.

[84] *Update of Timeline by the OECD/G20 Inclusive Framework on BEPS,* (December 18, 2023), available at https://www.oecd.org/tax/beps/update-pillar-one-timeline-beps-inclusive-framework-december-2023.pdf.

[85] Pillar One Blueprint, pars. 9, 89, and 847.

India) have expressed objections to the MLC's proposed treatment of withholding taxes.[86] Further, the MLC neither resolves how to ensure the rescission of DSTs and preclude any new such measures, nor addresses Amount B, which is instead the subject of a new report published this year, describing an optional (rather than mandatory) determination of Amount B, at the election of each jurisdiction.[87] The MLC also departs from earlier iterations of the operation of Pillar One in that, rather than requiring that fiscally autonomous territories be treated as separate jurisdiction, the MLC allows a jurisdictional election to apply Pillar One territorially.[88] For example, the United States may choose to require that Puerto Rico be treated as part of the United States for purposes of Amount A.

Unlike earlier documents, the MLC and related documents were not offered by the OECD for public consultation. In place of such opportunity for comment, the Secretary contemporaneously opened a public comment period on the October documents, requesting comments by December 11, 2023.[89] The MLC enters into force only when ratified by 30 countries accounting for at least 60 percent of the ultimate parent entities of MNEs initially expected to be in scope for Amount A. Thus, the MLC cannot enter into force without ratification by the United States.[90]

The following discussion of key aspects of Pillar One is based on the MLC and related documents released in October 2023, which in turn derive from a progress report published in July 2022[91] and an earlier report on pricing redeterminations related to routine return reportable to market jurisdictions under Amount B.[92] The aspects discussed below are the scope and required nexus, including limited exclusions, revenue thresholds, and identification of eligible market jurisdictions to whom taxing rights are ceded; determination of Amount A, including a proposed marketing and distribution profits safe harbor ("MDSH") and the elimination of excess profits; the status of efforts to streamline the determination of Amount B; and the extent to which the proposals achieve tax certainty by preventing disputes and requiring alternative dispute

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[86] See MLC, footnotes 2, 3, and 4, to Article 5 (Allocation of Profit Associated with Revenues in the Market) in which Brazil, Colombia, and India express objections to various components of the required calculations.

[87] OECD (2024), *Pillar One - Amount B: Inclusive Framework on BEPS* ("February 2024 Amount B Report"), OECD/G20 Base Erosion and Profit Shifting Project, Paris, available at https://doi.org/10.1787/21ea168b-en.

[88] MLC, Article 42.

[89] Comments submitted by public stakeholders are available at https://home.treasury.gov/public-input-on-draft-oecdg20-inclusive-framework-pillar-one-multilateral-convention-text.

[90] MLC, Article 48 (Entry into Force) and Annex I. Ratifying jurisdictions must represent at least 600 points of the 1000 points available. Of the total 1000 points available, 463 points are allocated to the United States.

[91] OECD (July 2022) *Progress Report on Amount A of Pillar One* ("July Progress Report"), OECD Paris https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf.

[92] OECD (2022) *Public Consultation Document Amount B under Pillar One* ("Amount B Report"), OECD Paris https://www.oecd.org/tax/beps/public-consultation-document-pillar-one-amount-b-2022.pdf.

resolutions mechanisms in certain cases. A brief overview of the public comments provided to Treasury is also included after the discussion of these various aspects.

**Scope and nexus**

To determine whether a taxpayer is within scope of Pillar One (*i.e.*, a "covered entity"), both revenue thresholds and the nature of activities are considered.[93] A covered entity is defined as an entity in a multinational group, or a covered group, where the adjusted revenues of the group for the relevant period are greater than €20 billion, and the pre-tax profit margin of the group is greater than 10 percent. "Pre-tax profit margin" is the group adjusted profit before tax divided by adjusted revenue of the group. If the entity was not a part of the covered group in the preceding two years, it is within scope only if it meets the thresholds for two of four preceding periods, as well as the subject period.

Revenues and profits from certain industries are excluded (either for all purposes or for purposes other than applying the scope tests), including qualifying extractives, regulated financial services, defense industry, and autonomous domestic businesses.[94] However, in certain cases, a particular line of business or segment may be treated as a standalone entity that is within scope as a disclosed segment.[95]

Together, the revenue thresholds and activity tests are intended to help identify the markets in which the end user is located, both by applying revenue sourcing rules that will vary with the type of service or good as well as particular market revenue thresholds.[96] Revenues are treated as arising in a jurisdiction, or sourced to a jurisdiction, if determined under a reliable method within the meaning of Articles 6 and 7, as well as Annex D. If no such reliable method exists, default allocation keys must be applied.[97] In general, a method is a reliable method only if based on reliable indicators of a type enumerated in Annex D for the type of adjusted revenue in question. In the absence of reliable indicators, allocation keys may be used in certain circumstances. Advance certainty with respect to reliable indicators is available within the framework of Article 29.

A covered entity or group has nexus with a jurisdiction for the relevant taxable period if its revenues arising in the jurisdiction are equal to or greater than €1 million. However, if the

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[93] See MLC, Articles 2 and 3, and Annex B Sections 1 and 2.

[94] MLC, Article 3 (defining "covered group" and referring to Annex C) and Annex C (providing rules to determine status of regulated financial (Sec. 2), qualifying extractives (Sec. 3), disclosed segments (Sec. 4), autonomous domestic businesses (Sec. 5), and defence groups (Sec. 6)); see also July Progress Report, pp. 10-12, and Schedules B and C, pp. 32-58.

[95] See MLC, Annex C Section 4 (regarding disclosed segments).

[96] See MLC, Articles 6 and 7, and Annex D.

[97] MLC, Article 6(4). The relevant default allocation keys include a component allocation key for sales of components, a service allocation key for the provision of services, and a global allocation key for all other cases. See also MLC, Article 7.

jurisdiction's GDP is less than €40 billion, nexus is satisfied if the covered group's revenues in the jurisdiction are equal to or greater than €250,000.[98]

The use of consolidated financial statements of a multinational group prepared using acceptable financial accounting standards such as Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS") remains unchanged from earlier iterations.[99]

**Amount A: Allocation of the new taxing right**

Once scope and nexus have been determined, the portion of residual profits that are to be allocated to a particular market jurisdiction is identified by use of a formula.

Amount A of Pillar One works by reallocating taxing rights on 25 percent of the residual profits (*i.e.*, profits in excess of 10 percent of revenues) of covered groups to market jurisdictions, regardless of whether they have a physical presence in such jurisdictions.

The formula for this determination is as follows:

$$Allocated\ Profits = \max(0, Profits - [Revenues \times 0.1]) \times 0.25 \times {}^{Local}/_{Revenues}$$

where –

*Allocated Profits* represents the amount of profit allocated to the jurisdiction,

*Profits* is the adjusted profit before tax, which is the financial accounting profit or loss of a covered group, adjusted to exclude tax expense or tax income and other items,

*Revenues* is the adjusted revenues of the covered group,

*Revenues* x 0.1 is the 10 percent allowed return on adjusted revenues, and

*Local/Revenues* is the allocation key that represents the ratio of adjusted revenues arising in that jurisdiction (or "*Local*") to the adjusted revenues of the whole group (or "*Revenues*"). [100]

Safe harbor for marketing and distribution (MDSH)

After determining the portion of profits that may be eligible to reallocate to a jurisdiction, the MDSH may also be available for certain covered groups.[101] If the MDSH applies, then all or a portion of the amount eligible for allocation under Amount A is reduced. This adjustment

[98] See MLC, Article 8.

[99] MLC, Article 2(g); July Progress Report, p. 24; Pillar One Blueprint, p. 101.

[100] MLC, Articles 2(d) and 5(1); see also July Progress Report, pp. 15-17.

[101] MLC, Article 5; see also MLC, Article 5(1)(b) (limiting application of the MDSH to jurisdictions in which the covered group has adjusted elimination profit (or loss) greater than or equal to €50 million).

downwards of the profits allocated to the jurisdiction is intended to relieve double taxation that may result if a covered entity has already reported profits to the jurisdiction under existing tax rules, including existing transfer pricing rules. Although the safe harbor has been discussed in terms of marketing and distribution, its calculation is prescribed in terms of determining a fixed rate of return on either depreciation and payroll ("RODP") or revenues in a particular jurisdiction (whichever is higher) to establish a cap on allocable residual profits more generally (looking at "nonroutine returns" within the jurisdiction) and permits a fixed offset percentage of those returns to be used to offset Amount A. The applicable offset percentage is determined by jurisdiction ("jurisdictional offset percentage").[102] The MDSH also takes into account certain withholding taxes (*i.e.*, those imposed on deductible payments to group entities) subject to specific reduction factors (ranging between 15 percent and 70 percent), as well as the exclusion for routine profits and the jurisdictional offset percentage discussed above. If adequate returns for routine in-country RODP are already reported in a jurisdiction, or if the returns already reported in a jurisdiction exceed the amount eligible for allocation under Amount A, then no allocation is to be made to that jurisdiction.

This MDSH adjustment is subject to further deliberation at the OECD.[103]

Allocation and elimination of excess profits

The obligation to eliminate double taxation with respect to Amount A is also allocated among those jurisdictions identified as relieving jurisdictions for a covered group. The process for allocating such amounts involves several computational steps but no required connection between the relieving jurisdiction and the relevant market jurisdiction. First, there is a calculation of the elimination profit (or loss),[104] which is a sum of financial accounting profit or loss in a jurisdiction, adjusted for various items, similar to the concept of Global Anti-Base Erosion income in Pillar Two (discussed below). Second, there is an identification of jurisdictions for which the elimination profit equals at least 95 percent of the group's total profit.[105] Third, the jurisdictions are grouped into four tiers, depending on profitability as measured by reference to RODP in the jurisdiction relative to the overall profitability of the group.[106] Finally, the obligation to eliminate double taxation is allocated to the jurisdictions with the highest RODP and iteratively to the next highest RODP until the obligation to eliminate double taxation has been fully allocated.[107]

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[102] The applicable jurisdictional offsetting percentage required by Article 5(d) of the MLC is 90 percent if the jurisdiction is a low depreciation and payroll jurisdiction, 25 percent if it is a lower income jurisdiction, and 35 percent for all others.

[103] See MLC, Article 5 (identifying objections expressed by Brazil, Colombia, and India with respect to certain aspects of the rules), and also objections expressed in footnotes July Progress Report, p. 17, fn. 3.

[104] MLC, Annex B Section 4; see also July Progress Report, Schedule I, pp. 86-94.

[105] MLC, Article 10.

[106] MLC, Article 11; see also July Progress Report, p. 20, par. 5.

[107] MLC, Article 11; see also July Progress Report, pp. 20-22 and Schedule J, p. 93-94.

If there are multiple Tier 1 jurisdictions (*i.e.*, jurisdictions in which the RODP in that jurisdiction is greater than 1500 percent of the RODP of the group), the jurisdiction with the highest RODP eliminates double taxation through a reduction of taxable profits until that jurisdiction's RODP is equal to the RODP of the second jurisdiction. Once the first jurisdiction has the same RODP as the second jurisdiction, the jurisdictions jointly reduce their RODP until they are at the level of the third jurisdiction, which then also reduces its RODP. If double taxation is not fully relieved from Tier 1 profits, Tier 2 jurisdictions (*i.e.*, jurisdictions in which the adjusted RODP in that jurisdiction is greater than 150 percent of the RODP of the group) are required to relieve double taxation according to the same waterfall. If double taxation is not fully relieved from Tier 1 and Tier 2 jurisdictions, the same then applies to Tiers 3A (*i.e.*, jurisdictions in which the adjusted RODP in that jurisdiction is greater than 40 percent of the RODP of the group) and Tier 3B (*i.e.*, jurisdictions in which the adjusted RODP in that jurisdiction is greater than the elimination threshold RODP of the group).

Relief entities are entitled to relief from double taxation within their respective home jurisdiction with respect to income reallocated pursuant to Amount A.[108] At the discretion of the relieving jurisdiction, such relief may come in the form of a direct payment, a refundable tax credit, a non-refundable tax credit, or a deduction.[109]

**Amount B**

As stated above, the MLC does not address Amount B. Instead, Amount B is defined outside the framework of the MLC and will be reflected in updated transfer pricing guidelines. In a departure from earlier guidance on the nature of Amount B, the February 2024 Amount B Report provides that the streamlined Amount B is optional at the election of a jurisdiction. Earlier guidance had explained that because routine transactions are frequent sources of transfer pricing disputes, and that many jurisdictions have limited capacity to handle such disputes, the determination of profit margins on certain routine controlled transactions in accordance with a streamlined formulaic approach (including both a streamlined pricing methodology and a formula for identifying an arm's-length result where comparable transactions may be unavailable) should be mandatory.[110] Amount B is limited in scope to those transactions that can be reliably evaluated under a streamlined qualitative analysis and a streamlined pricing methodology, the outcome of which provides results that are consistent with existing transfer-pricing norms.

Because Amount B is limited to controlled transactions that involve routine distribution or marketing activities within the distributor or marketer's jurisdiction of residence, for which the distributor does not undertake significant risk, exemptions may be appropriate and the otherwise required detailed analysis of functions may be streamlined. In developing the criteria for determining what transactions should be considered within scope of Amount B, a

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[108] MLC, Article 9; see also MLC, Article 13 (Identification of Relief Entities Entitled to Elimination of Double Taxation).

[109] MLC, Article 12 (Provision of Relief for Amount A Taxation to Relief Entities).

[110] Amount B Report.

nonexclusive list of disqualifying activities, such as research and development, manufacturing, financing, or procurement, sales of intangible assets are included. If an existing advanced pricing agreement covers the transaction for the group, such transaction is excluded from the scope of Amount B.

Transactions in scope are eligible for a streamlined pricing methodology, a variation of a transactional net margin method. Work with respect to the development of both common benchmarking search criteria and a global dataset has led to development of a pricing matrix to be used in determination of Amount B.[111] The principles described in the development of the most recent report include the flexibility of existing transfer pricing guidelines requiring a balance of reliability of the methods chosen, as well as administrability, and a commitment to periodic updates every five years.

**Tax certainty**

Improved administrative procedures that both prevent disputes as well as offer robust dispute resolutions methods have been objectives of Pillar One since the Blueprint was published in 2020. The scope and type of measures, however, have changed over time. The MLC and related documents include a framework for preventing and resolving disputes regarding various aspects of Amount A and related issues and require that ratifying jurisdictions adopt this framework.[112] The proposed streamlining of Amount B is elective for ratifying jurisdictions. Finally, whether a new tax provision in a jurisdiction is a prohibited DST or similar unilateral provision is subject to a peer review by the Conference of Parties, consisting of all parties to the MLC.[113]

Tax certainty for Amount A

In addition to the dispute prevention effect of broad consensus on proper use of specified percentages and formulas to compute Amount A, an administrative framework that includes uniform standards for documentation, currency conversion rules, and filing requirements may minimize disputes. These dispute prevention measures are bolstered by a framework that allows covered entities to seek certainty at different stages of the process of determining Amount A. The covered group may seek certainty as to whether it is within scope, as well as advance certainty as to its chosen methodology, or comprehensive certainty as to its position on Amount A. Determinations in response to requests for certainty are made by review panels of independent experts, with the intent to ensure uniform treatment of the covered group across multiple jurisdictions.

As the discussions proceeded regarding the need for new dispute resolution mechanisms to provide tax certainty with respect to Amount A and Pillar One generally, few details were

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[111] February 2024 Amount B Report, pp. 26-31, describes the pricing matrix and how its reliability is tested; see also Amount B Report, p. 30.

[112] MLC, Articles 22 through 36, generally; Tax Certainty Understanding.

[113] MLC, Articles 38 through 40.

provided. One example sometimes cited was mandatory arbitration of the type provided in several of the most recent U.S. bilateral income tax treaties.[114] However, the tax certainty provisions set forth in the MLC with respect to Amount A, as reflected in the Explanatory Statement and in the Tax Certainty Understanding, differ significantly from the nature of arbitration accepted in U.S. tax treaties (or in the U.S. model treaty) in allowing access to the dispute resolution panels at different stages and in the makeup of a final determination panel from a pool of independent experts.

Tax certainty with respect to issues related to Amount A is also distinct from the type of mandatory arbitration available under U.S. tax treaties currently. First, the scope of issues eligible for dispute resolution is limited to "related issues," defined as an issue that is covered by provisions equivalent to Articles 5, 7, or 9 of the OECD Model treaty (or the UN Model treaty)[115] and has an effect on either elimination of double tax by covered jurisdictions or on elimination profit for covered jurisdictions. Second, the process for dispute resolution of related issues is elective under Article 36. As a result, the extent to which asymmetries among existing U.S. tax treaties or agreements may be exploited is unclear, because of the nature of the new taxing rights as an overlay on traditional transfer pricing rules, the continued relevance of existing treaties, and the elective streamlined process with respect to Amount B, described below. In addition, safe harbors for advanced pricing agreements in place are provided, with the expectation that future such agreements would be in conformity with Pillar One principles.

Tax certainty for Amount B

As stated above, the MLC is silent on Amount B, prescribing no specific administrative procedures for assuring certainty. Instead, adoption of the streamlined Amount B is optional. More importantly, the definition of distributor[116] narrows the range of issues eligible for the streamlined methodologies and thus limits the extent to which disputes are prevented by adoption of Amount B. Because the need for Amount B arose as a result of concern about disproportionate number of transfer pricing cases involving routine distribution issues and the fact that such resource-intensive disputes often arise in jurisdictions that lack the resources to process such cases efficiently,[117] additional administrative measures may be needed to streamline not only the computational methodology but also the administrative review. The failure to require conformity to the streamlined Amount B is contrary to the objective of tax certainty.

[114] Bilateral tax treaties of the United States with Belgium, Canada, France, Germany, Japan, Spain, and Switzerland include provisions in which arbitration in certain disputes between competent authorities is mandatory. A table of all bilateral treaties can be found on the IRS website: https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.

[115] See OECD Model Treaty, Articles 5 (Permanent establishment), 7 (Business profits), and 9 (Associated enterprises).

[116] February 2024 Amount B Report, Section 3.2 (Scoping Criteria), par. 14.a., provides that reselling of services and distribution of digital goods cannot be a qualifying transaction.

[117] February 2024 Amount B Report, p. 14, par. 3; Amount B Report, pp. 28-29, par. 43.

DSTs and other unilateral measures

As stated above, the revocation or removal of the unilateral measures and DSTs enacted in several jurisdictions to attempt to address challenges of digitalization of the economy was a predicate to the agreement that resulted in the new taxing right proposed under Pillar One. That commitment is reflected in the moratorium with respect to enforcement of DSTs and unilateral measures that was included in the October 2021 Statement. On February 15, 2024, the United States and five other countries (the United Kingdom, Austria, France, Italy, and Spain) announced that they had extended their agreement to suspend enforcement of existing DSTs, through June 30, 2024. They also agreed to discuss commitments with respect to unilateral measures imposed on taxpayers after June 30, 2024.[118] Over the past year, Canada has moved forward with its intent to enact a DST. Because Canada had no prior DST, Canada was not a signatory to the extension of the moratorium on DSTs.

The MLC includes a definition of DSTs and similar measures prohibited under Pillar One.[119] The fact that a tax is not within the scope of covered taxes is not by itself enough to characterize a tax as a DST. Whether a tax is a DST or similar measure is determined by reference to criteria such as whether the tax is based on location of users or other market-based factors; is applicable only to nonresidents, either explicitly or in practice, because of revenue thresholds or other factors that insulate local business from such taxes; and is not within the scope of covered taxes in bilateral agreements intended to relieve double taxation. Value-added taxes, transaction taxes, and anti-abuse measures are generally not within the scope of the prohibited measures. Whether a provision is within the meaning of the definition DSTs and relevant similar measures is to be decided by the Conference of Parties in accordance with a review process outlined in Annex H.

No jurisdiction joining the MLC may enact or enforce a DST. A jurisdiction in violation of that prohibition cannot receive any allocation of residual profits under Amount A.[120]

**Public consultation conducted by Treasury**

On October 11, 2023, the same day that the draft text of the MLC and accompanying documents were published, Treasury announced a request for public comments on the draft text and accompanying material.[121] The announcement emphasized the importance of soliciting

[118] A press release and copy of the formal Joint Statement is available at https://home.treasury.gov/news/press-releases/jy2098. The original agreement, entered into after the October 2021 global agreement was announced, expired at the end of 2023.

[119] MLC, Article 39(2); see also MLC, Article 38 (Removal of Existing Measures) and Annex A (List of Existing Measures Subject to Removal).

[120] MLC, Article 39(1).

[121] "Treasury Seeks Public Input on Draft OECD/G20 Inclusive Framework Pillar One Multilateral Convention Text" (Oct. 11, 2023), available at https://home.treasury.gov/news/press-releases/jy1789. The announcement quoted Assistant Secretary for Tax Policy, Lily Batchelder, as saying that the release of the draft MLC and accompanying documents is a key step in the Pillar One negotiations and reflects countless hours of discussions, across multiple U.S. administrations, and among hundreds of negotiators.

public comments, in light of the significant reform to the international tax system that Pillar One would represent as well as the breadth and complexity of the changes proposed, "to ensure transparency, to facilitate the resolution of several remaining open issues, and to hear whether the proposed framework would be workable for U.S. taxpayers and other stakeholders." Treasury was "especially interested in comments related to novel issues identified by a review of the complete text, implementation and administrability issues (including the balance between simplification and technical precision), and technical adjustments to address errors or clarify the operation of the Pillar One MLC provisions." Comments were due by December 11, 2023.

More than 20 comments were submitted to Treasury by members of the business community, industry groups, advisers, trade organizations, individuals, and other stakeholders (collectively, "stakeholders"). On December 19, 2023, Treasury published those comments.[122] The following is a summary of the views provided in the comments.

Stakeholders broadly appreciated the opportunity to comment on the draft text and accompanying documents, as this was the first time that stakeholders had the opportunity to review a complete draft text of the MLC. Stakeholders agreed that the consultation process is imperative in order to achieve a workable solution that provides greater certainty and stability in the international tax system. Comments commended Treasury's efforts and urged Treasury to continue to work to address the broad policy goals and specific technical issues raised, especially given the significant effect Pillar One would have on the largest U.S. companies.

The comments raised many specific technical issues, but the comments generally shared several broad themes: (1) continued, strong support for reaching a consensus-based solution to the elimination of DSTs and other unilateral measures; (2) desire for a better balance between administrability and precision; (3) concerns about the complexity and administrability of the proposed rules for businesses and tax authorities; (4) requests for clarity and greater simplification in order for the proposed system to be sustainable; (5) uncertainty with respect to the policy or economic rationale for certain design features; (6) concerns that the complex formulas, including the various cliff effects, do not provide for predictable or intuitive results and, instead, may produce distortive and arbitrary results; and (7) concerns that political negotiations, and the remaining reservations by India, Brazil, and Colombia, may make avoiding double taxation difficult.

Stakeholders highlighted significant technical enhancements made since previously released consultation documents, which appear to incorporate prior stakeholder comments. Examples of such enhancements included the introduction of the autonomous domestic business exemption, the refinements and attempted simplification made to the revenue sourcing rules, accounting for certain withholding taxes as part of the MDSH, the inclusion of novel dispute prevention and dispute resolution procedures, as well as revisions to the sections relating to the elimination of DSTs and other relevant similar measures ("RSMs"). These enhancements, while appreciated, were nonetheless the subject of substantial discussion.

[122] All public comments submitted to Treasury relating to the draft MLC published on October 11, 2023, may be found on the Department of the Treasury's website, available at https://home.treasury.gov/public-input-on-draft-oecdg20-inclusive-framework-pillar-one-multilateral-convention-text.

With respect to the autonomous domestic business exemption, for example, stakeholders argued that the proposed exemption is too narrow (*i.e.*, not available for most large MNEs with integrated businesses or that otherwise operate autonomous domestic businesses as well as other businesses in the same jurisdiction) and that its mechanics create a "cliff effect" if certain thresholds are breached, which would require constant monitoring.

The revenue sourcing rules continue to present significant challenges, and requests were made for further simplification in order to achieve a better balance between administrability and precision. There is wide concern that the current rules are exceedingly complex and would impose unrealistic, excessive compliance burdens on taxpayers. For many, the rules would not be workable. The revenue sourcing rules require a substantial amount of granular data, much of which stakeholders indicated would be outside the normal and ordinary course of business and difficult to use reliably. Stakeholders also expressed concern with the proposed allocation keys, suggesting that the allocation keys are arbitrary, likely to produce distortive results, and may disadvantage the United States (*e.g.*, the allocation key based on GDP could result in reallocating to other jurisdictions revenue properly attributable to U.S. activities).

The modifications made to the MDSH to account for certain withholding taxes imposed by market jurisdictions were appreciated, but the limited extent to which such taxes are accounted for, together with other limitations incorporated into the MDSH, were met with criticism. The MDSH is intended to prevent double counting or taxation by reducing the Amount A allocated to a particular market jurisdiction to the extent that jurisdiction already has taxing rights over the group's profits under existing tax rules. Given that withholding taxes by their very nature are a jurisdiction exercising taxing rights, stakeholders argued that, to achieve the intended purpose of the MDSH, such taxes should be taken into account. Stakeholders expressed uncertainty regarding any economic rationale for subjecting withholding taxes to numerous limitations, including a withholding tax specific reduction factor, that effectively haircuts the amount taken into account. Similar concerns were expressed with other key design elements of the MDSH (*e.g.*, the jurisdictional offset percentage), which further limit the MDSH, causing many stakeholders to question whether political negotiations have rendered the MDSH ineffective in avoiding double counting of taxable profits in market jurisdictions. Further questions were raised as to the effect future political negotiations will have on the final design of the MDSH, given the lack of consensus on the design of the MDSH, as indicated by reservations from Brazil, India, and Colombia.

In addition, stakeholders noted that many businesses within scope of Amount A will be unable to qualify for the MDSH because of the relatively narrow scope of the rule. This could be due to one of several reasons. It may be that the business models to which the MDSH applies are those MNEs operating through a consolidated supply chain, not MNEs operating through a nonconsolidated supply chain. Another reason may be that there is a misalignment between the high *de minimis* threshold for the MDSH to apply with respect to a jurisdiction (*i.e.*, only applies in jurisdiction in which the MNE has taxable profit of €50 million or more) and the relatively low nexus threshold in a jurisdiction for Amount A to apply (*i.e.*, €1 million (or €250,000 in jurisdictions in which GDP is less than €40 billion)). In the latter case, MNEs would be subject to double taxation in jurisdictions in which the nexus threshold is met but the *de minimis* threshold is not.

Stakeholders expressed strong support for dispute prevention and dispute resolution mechanisms as necessary to achieve the goal of stability and certainty in the international tax system. The novel approaches presented in the draft MLC were viewed as admirable. And although stakeholders appreciated components of the dispute prevention and dispute resolution provisions, many stakeholders expressed concern that the proposals are complex and fall short of providing certainty or stability. For example, issues raised related to: various aspects of the review, determination, and dispute resolution panels; the potential inability to access MAP in situations in which there is no covered tax agreement in effect; and concerns about the timeframe for obtaining certainty and resolving disputes. Stakeholders provided a number of suggested areas of improvement, including, for example, reducing the layers of review, increasing the role of the company, streamlining the processes, and expanding the scope of issues subject to mandatory binding dispute resolution process.

The comments reiterated that the importance of the provisions relating to DSTs and other unilateral RSM cannot be overstated. Stakeholders appreciate the effort put forth in the draft MLC, yet significant concerns remain and must be addressed in order for the MLC to provide stability to the international tax system. Considerable comments were provided with respect to the various elements of the definition of DSTs and other RSMs. Requests were made to improve the scope and definition, reflecting concern that the current draft is too narrow, limiting, and susceptible to circumvention. Additional comments were provided with respect to concerns relating to the review process and early clarification on DSTs and RSMs as well as the provisions denying Amount A allocations for any jurisdiction that has or enacts such measures. Stakeholders requested that the MLC be revised to provide a clear and definitive obligation to eliminate existing, and preclude the enactment of new, DSTs and other similar destabilizing measures. This includes with respect to significant economic presence nexus rules, which stakeholders believe should be treated similar to, and subject to the same standstill and withdrawal commitment as, DSTs. Stakeholders further contend that, as written, the MLC is not a total elimination of DSTs. Some even pointed out language that could be interpreted to permit a jurisdiction to choose whether to collect Amount A allocations or impose a DST or other similar measure, depending on which is more beneficial.

The technical issues discussed above are not meant to constitute an exhaustive list. Other important issues and concerns were discussed by stakeholders, including with respect to the narrowness of certain exceptions (*e.g.*, extractions exclusion), the complexity of definitions, areas in which the rules may either not work or create distortions, compliance and need for common documentation package, balance between the level of detail necessary and the confidential taxpayer information, the excessive flexibility provided for jurisdictions to relieve double taxation, as well as requests for clarification as to how Amount A interacts with Amount B and Pillar Two. And although Amount B was not included in the draft text of the MLC and accompany documents, stakeholders took the opportunity to express their views regarding Amount B. The comments fully endorsed support for the stated goals of Amount B and argued that it was integral and critical to achieving Pillar One's stated goal of stabilizing the international tax system. Stakeholders emphasized that Amount B could streamline, simplify, and reduce transfer pricing disputes, and requested that its scope be expanded to cover a broader set of transactions.

In sum, despite uniform support for reaching a consensus-based solution, questions remain about the viability of the draft MLC to achieve a workable solution for taxpayers and tax authorities, due to its complexity, purported arbitrary results, and continued reservations by certain countries with respect to important aspects of the proposal. Stakeholders asserted that in order for Pillar One to achieve enhanced stability and certainty in the international tax system the policy considerations and technical issues raised in the comments must be addressed.

### B. Pillar Two

In December 2021, the OECD published "Global Anti-Base Erosion Model Rules (Pillar Two)," which provides for a system of taxation based on financial accounts applying a minimum rate of 15 percent on a jurisdictional (country-by-country) basis (the "Model Rules").[123] In March 2022, the OECD published general commentary (and related examples) on the Model Rules,[124] and in December 2022, the OECD published guidance on a transitional safe harbor, a framework for a permanent safe harbor, and transitional penalty relief.[125] In 2023, the OECD published three sets of administrative guidance on the Model Rules to address certain specific questions in need of clarification and simplification.[126] A number of jurisdictions have agreed in principle to adopt Pillar Two, and some have already enacted legislation or proposed legislation to adopt at least some aspects of the Model Rules.

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123 OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-theeconomy-global-anti-base-erosion-model-rules-pillar-two htm.

124 OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), First Edition: Inclusive Framework on BEPS*, OECD Publishing, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-thedigitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf. For the related examples, see OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy –Global Anti-Base Erosion Model Rules (Pillar Two) Examples*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisationof-the-economy-global-anti-base-erosion-model-rules-pillar-two-examples.pdf.

125 OECD (2022), *Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)*, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, https://www.oecd.org/tax/beps/safe-harbours-and-penalty-relief-global-anti-base-erosion-rules-pillar-two.pdf.

126 OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two.pdf; OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*, July 2023, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosionrules-pillar-two-july-2023.pdf; OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*, December 2023, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, http://www.oecd.org/tax/beps/administrative-guidance-global-antibase-erosion-rules-pillar-two-december-2023.pdf.

**The Model Rules**

Pillar Two seeks to establish a set of rules to enforce a minimum global level of income taxation for MNEs. The intent is to address structures that allow for the shifting of profits into jurisdictions with low or zero tax rates. For each country in which an MNE operates, the Model Rules calculate a top-up tax (which may be zero) on an income tax base that follows from financial accounting principles. This country-by-country approach may limit the tax savings from shifting income between foreign countries. For example, if either a CFC or its branch does not pay an effective rate of tax equal to 15 percent on its income in its country of organization or operation, a top-up tax may be imposed by that country or another country under the rules described below.

**Companies in scope**

The Model Rules apply to MNE groups (and their constituent entities) that have annual revenue of €750 million or more in the consolidated financial statements of the ultimate parent entity in at least two of the four fiscal years immediately preceding the tested fiscal year.[127] An MNE group (or here just an MNE) means a collection of entities that are related through ownership or control such that the assets, liabilities, income, expenses, and cash flows of those entities are included in the consolidated financial statements of the ultimate parent entity with at least one entity (or permanent establishment) that is not located in the jurisdiction of the ultimate parent entity.[128] The ultimate parent entity generally is one that owns (directly or indirectly) a controlling interest in any other entity and in which no other entity owns a controlling interest.[129]

**Application of the top-up tax**

Top-up tax is due with respect to income in a jurisdiction if book income ("Globe income," discussed below) in the jurisdiction is subject to an effective tax rate ("ETR") of less than 15 percent. The additional top-up tax may be collected first by the source country,[130] second by the residence country of the MNE's ultimate parent entity,[131] third by the residence country of a lower-tier parent entity,[132] and finally by the residence country of any other affiliated entity.[133]

[127] Art. 1.1.1 of the Model Rules.

[128] Art. 1.2.1 and 1.2.2 of the Model Rules.

[129] Art. 1.4.1 of the Model Rules.

[130] Under a "qualified domestic minimum top-up tax" ("QDMTT").

[131] Under an "income inclusion rule" ("IIR").

[132] Also under an IIR.

[133] Under an "undertaxed profits rule" ("UTPR").

### Globe income and the base of the top-up tax

Globe income (or loss) in a country generally is the net income (or loss) determined for an entity in preparing consolidated financial statements of the ultimate parent entity.[134] If Globe income in a country is subject to an ETR of less than 15 percent, then the Globe income is subject to a top-up tax.

The ETR for a jurisdiction is equal to the sum of the "adjusted covered taxes" paid in that jurisdiction divided by the net Globe income in that jurisdiction.[135] Adjusted covered taxes are the current tax expenses that have accrued for purposes of calculating that year's financial accounting net income, adjusted for certain deferred tax assets and deferred tax expenses, as well as other differences between tax reporting and financial reporting.[136]

The base of the top-up tax ("excess profit") generally is Globe income[137] less the substance-based income exclusion for the country.[138] The substance-based income exclusion is five percent of (1) eligible payroll costs in the country and (2) the carrying value of eligible tangible assets in the country.[139] Thus, for companies that have payroll costs and eligible tangible assets in the relevant country, the amount of the top-up tax always is less than the amount of additional tax necessary to increase the ETR on Globe income to 15 percent.

In other words:

Top-up tax = max(0, (15% – ETR) x (net Globe income – substance-based income exclusion))[140]

### Ordering of the top-up tax

#### Qualified domestic minimum top-up tax ("QDMTT")

The primary right to tax income (including Globe income) arising in a jurisdiction is with the jurisdiction (the source country) itself. Thus, if in country X an MNE earns Globe income that is subject to an ETR of less than 15 percent, country X has priority in applying a top-up tax.

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[134] Art. 3.1.2 of the Model Rules. Several adjustments are made. Art 3.2.1 of the Model Rules.

[135] Art. 5.1.1 of the Model Rules.

[136] Art. 4.1 of the Model Rules.

[137] "Globe" income is an acronym for Global Anti-Base Erosion income (officially, "GloBE" income).

[138] Art. 5.2.3 of the Model Rules.

[139] Art. 5.3 of the Model Rules. Initially, the substance-based income exclusion is set to be 10 percent for eligible payroll costs and eight percent for the carrying value of eligible tangible assets, both phased down to five percent over a 10-year transition period.

[140] See Art. 5.2 of the Model Rules.

The mechanism for applying that top-up tax (*i.e.*, a top-up tax on domestic income) is the QDMTT.

A natural question arises: why would country X choose to apply a new tax (the QDMTT) instead of simply changing its local corporate tax, whether by increasing the rate (to 15 percent) or expanding the base (to resemble Globe income more closely)? The answer is that the tax base for purposes of determining an MNE's ETR is generally greater than the tax base for purposes of determining the top-up tax. A 15-percent corporate tax that followed the Model Rules in determining its tax base would tend to collect more corporate tax than required under the top-up tax.[141] In other words, the QDMTT represents the only way under Pillar Two for a country to collect in every case the minimum tax liability due with respect to Globe income arising in its jurisdiction.

As described below, if a source country does not impose a QDMTT, the Model Rules allow other countries to collect any top-up tax due with respect to Globe income earned in the source country.

Income inclusion rule ("IIR")

The secondary right to collect a top-up tax with respect to Globe income earned in a source country is with the jurisdiction of the MNE's ultimate parent entity.[142] This top-up tax is known as the IIR. The mechanism is like other tax regimes ("CFC taxes") that require an ultimate parent entity to pay current tax on the income of controlled foreign corporations ("CFCs"), including Subpart F income and GILTI under U.S. law.[143] In terms of ordering, QDMTTs come before CFC taxes, and CFC taxes come before IIRs (which all come before UTPR, as discussed below).

If the jurisdiction of the ultimate parent entity does not impose an IIR, jurisdictions of any intermediate parent entities (*i.e.*, between the ultimate parent entity and the source country) are allowed to collect under their own IIRs any top-up tax due with respect to Globe income earned in the source country. The IIR has ordering rules to ensure that Globe income in a country is subject to top-up tax exactly once.

Undertaxed profits rule ("UTPR")

The final mechanism providing for the collection of top-up tax is the UTPR. If a top-up tax is due, but the source country does not impose a QDMTT and no parent entity is in a jurisdiction imposing an IIR, then countries in which other MNE affiliates are located may collect the top-up tax under a UTPR. Those countries share the top-up tax according to the

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[141] A 15-percent corporate tax that followed the base of the top-up tax would be treated in most cases as having an ETR of less than 15 percent.

[142] Art. 2.1.1 to 2.1.3 of the Model Rules.

[143] See generally Part I of this document.

number of employees in each UTPR jurisdiction and the value of tangible assets in each UTPR jurisdiction.[144]

**Tax credits, grants, and the ETR**

The ETR on Globe income in a source country may depend on the treatment of certain incentives provided by the country. Grants are treated as additions to Globe income; tax credits are treated as reductions to taxes paid for purposes of calculating the ETR. Certain refundable tax credits (*i.e.*, "qualified refundable tax credits" or "QRTCs"), however, are treated as grants and, therefore, increase Globe income rather than reduce taxes paid.[145]

For example, consider an MNE in country X with Globe income of 100x, taxes of 20x, and tax credits of 6x. Before accounting for credits, the MNE has an ETR of 20 percent (20x/100x). Whether the MNE is subject to top-up tax depends on the treatment of the credits. If the tax credits are QRTCs, then the ETR is 18.9 percent (20x/106x), well above 15 percent. If the tax credits are not QRTCs, however, then the ETR is 14 percent (14x/100x) and the MNE is subject to top-up tax.

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[144] The formula is: UTPR percentage = (50 percent of number of employees in a UTPR jurisdiction / number of employees in all UTPR jurisdictions) + (50 percent of net book value of tangible assets in a UTPR jurisdiction / net book value of tangible assets in all UTPR jurisdictions). Thus, the allocation of UTPR liability is half by number of employees and half by net book value of tangible assets.

[145] Art. 4.1.2(d) of the Model Rules. The Model Rules generally define QRTC as "a refundable tax credit designed in a way such that it must be paid as cash or available as cash equivalents within four years from when … [the MNE] satisfies the conditions for receiving the credit under the laws of the jurisdiction granting the credit."

# III. ECONOMIC CONSIDERATIONS RELATED TO PILLAR ONE

## A. Background

In October 2021, the OECD announced that more than 140 members of the OECD/G-20 Inclusive Framework on Base Erosion and Profit Shifting agreed to the implementation of a Two-Pillar international tax proposal.[146] As noted in Part II.A. of this document, Pillar One of this proposal would in part revise the principles governing profit allocation and the extent and nature of nexus that is deemed sufficient to allow a country (the "market jurisdiction") to tax some portion of an MNE's income (*i.e.,* Amount A), as well as propose a simplified method of applying arms' length principles to determine a return on sales based on guidance provided in OECD transfer pricing guidelines (*i.e.*, Amount B). As Pillar One has not been implemented, and as some (but not all) important details related to its design were agreed upon only in 2021, studies analyzing the economic effects of this proposal are limited. Therefore, this section largely focuses on the design of Pillar One and on qualitative discussions of the implications of partial implementation.

## B. Implementation of Pillar One

### 1. Destination-based income taxation

At this time, important aspects of the mechanics of Pillar One have yet to be resolved. However, economists have analyzed systems of taxing cross-border income that share the key attribute of Pillar One: the allocation of primary taxing rights to market jurisdictions (often referred to as a destination-based approach). Three prominent destination-based tax systems have been studied: (1) a destination-based cash flow tax, (2) sales-based formulary apportionment, and (3) residual profit allocation.[147] Because the location of production is likely more mobile than the location of the final consumer, destination-based tax systems may be more efficient at taxing cross-order income than traditional, origin-based systems. In addition, these systems may reduce the incentive to shift profits relative to present tax systems. However, each of these systems also introduces new administrative challenges. For example, while the location of the final consumer may be immobile, the location of sales—which is ultimately the observable measure upon which taxes would be based—may be more manipulable.[148]

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[146] OECD (2022), *Tax Incentives and the Global Minimum Corporate Tax – Reconsidering Tax Incentives After the GLOBE Rules*, OECD, Paris, https://www.oecd.org/investment/investment-policy/oecd-investment-tax-incentives-database-2022-update-brochure.pdf.

[147] For a more general discussion of the economic features and effects of destination-based approaches to taxing cross border income, see Joint Committee on Taxation, *Destination-Based Taxation and Border Adjustments* (JCX 20-17), May 22, 2017. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[148] For an empirical examination of the impact of sales shifting on profit shifting of U.S. MNEs, see Sébastian Laffitte and Farid Toubal, "Multinationals' Sales and Profit Shifting in Tax Havens," *American Economic Journal: Economic Policy*, vol. 14, no. 4, November 2022, pp. 371-396.

## 2. Destination-based cash flow tax[149]

From a cross-border tax perspective, the key feature of a destination-based cash flow tax is that, for a specific country, the tax base consists of proceeds[150] from the sale of goods and services to purchasers located in that country, regardless of where the goods and services were produced. In particular, proceeds derived from exports are exempt while proceeds from imports are taxable, allowing market jurisdictions full taxing rights to proceeds derived from sales to that jurisdiction.[151]

As mentioned above, relative to an origin-based tax, a destination-based cash flow tax limits profit shifting from the home country because the home-country tax on proceeds from sales to foreign jurisdictions is zero, so there is no tax incentive to locate proceeds in a tax haven (or any other country with a tax rate lower than that home country).[152] Because profit shifting incentives are minimized, so are incentives to locate investment or employment in low-tax jurisdictions for the sole reason of substantiating the allocation of more proceeds to those low-tax jurisdiction.

Pillar One is levied on income, and not cash flow, but resembles a destination-based cash flow tax to the extent that market jurisdictions are allocated greater taxing rights. A destination-based tax could resemble the limiting or unique case of the potential economic advantages of assigning taxing rights to market jurisdictions, as Pillar One aims to do. However, Pillar One, which applies to only a subset of profits and involves a global reallocation of taxing rights, is considerably more complicated than a destination-based cash flow tax and may share less of the economic benefits.

## 3. Sales-based formulary apportionment[153]

Under sales-based formulary apportionment, taxing rights to an MNE's global profits are allocated based on the proportion of its global sales to a particular market jurisdiction. Similar to

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[149] See Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön, and John Vella, "Taxing Profits in a Global Economy," *Oxford: Oxford University Press*, 2021, pp. 267-333.

[150] Under a destination-based cash flow tax, proceeds would be cash flow rather than income. However, from a cross-border perspective, the economic effects of a destination-based income tax are broadly similar to the economic effects of a destination-based cash flow tax. The term "proceeds" is used here to highlight that the analysis would be generally applicable to a tax base consisting of either income (such as under the Pillar One proposal) or cash flow. For more background on cash flow taxes, see Joint Committee on Taxation, *Background on Cash-Flow and Consumption-Based Approaches to Taxation* (JCX-14-16), March 18, 2016. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[151] An additional key feature includes the exemption of interest income and payments, as well as full expensing of capital equipment.

[152] In fact, the concept of residence is not critical in a destination-based tax system, although it may still be important when determining taxation of passive income.

[153] For an example of a sales-based formulary apportionment system, see Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits: A Proposal to Adopt a Formulary Profit Split," *Florida Tax Review*, vol. 9, no. 5, 2009, pp. 497-533. For more general discussions of the strengths and weaknesses

other destination-based taxes, income shifting and distortions to the location of economic activity are minimized to the extent that the location of sales is not easily manipulated. Sales-based formulary apportionment is viewed by some economists as a relatively simple and transparent system that appears fair in the sense that taxation is based on economic activity (including sales) in a jurisdiction.[154] However, some economists contend that sales-based formulary apportionment may distribute the tax base in a relatively arbitrary manner, thus resulting in inefficient incentives for firms and governments.[155] In addition, MNEs would be encouraged to report more sales (at least for purposes of the new formulary system) in low- or zero-tax jurisdictions and less sales in higher-tax jurisdictions to which a sale otherwise would be attributed.[156] The same critique (potential manipulation of the location of sales) applies if sales-based formulary apportionment were to be adopted unilaterally. Profits recognized as taxable by a host country may not match profits allocated to that host country based on sales. This misalignment would generally result in administrative challenges as well as double taxation.

Pillar One shares similarities with sales-based formulary apportionment, except that (1) taxing rights to only a portion of global profits are assigned on the basis of sales, (2) the formula for assigning taxing rights to that portion is more complicated and not directly proportional to sales, and (3) Pillar One attempts to determine the location of the final consumer. In particular, Pillar One would be close to sales-based formulary apportionment if (1) it applied to all MNEs and (2) Amount A were 100 percent of Adjusted Profit Before Tax (as defined by the OECD), instead of calculated as adjusted profit before tax, decreased by 10 percent of revenues of the MNE. One paper comparing a form of sales-based formulary apportionment with Pillar One argues that Pillar One is more distortionary to the extent that it would apply to a small number of large companies, and only to a subset of their profits.[157]

**4. Residual profit allocation**

Residual profit allocation resembles formulary apportionment to the extent that taxation of global profits is allocated on the basis of sales. In contrast to sales-based formulary apportionment, a routine return is allowed. In general, a residual profit allocation involves (1) an allocation of taxing rights on an MNE's profits representing a "routine" return (*i.e.*, normal return calculated by some arm's length pricing method) on activities and functions performed in particular jurisdictions to those jurisdictions, and (2) a destination-based allocation of taxing

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of sales-based formulary apportionment, see Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön, and John Vella, "Taxing Profits in a Global Economy," *Oxford: Oxford University Press*, 2021, pp. 139-150; and Harry Grubert, "Destination-Based Income Taxes: A Mismatch Made in Heaven," *Tax Law Review*, vol. 69, no. 1, Fall 2015, pp. 43-72.

[154] Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön, and John Vella, "Taxing Profit in a Global Economy," *Oxford University Press*, December 2020.

[155] The relatively arbitrary manner may not bear relation to where income is earned.

[156] Rosanne Altshuler and Harry Gruber, "Formula Apportionment: Is It Better Than the Current System and Are There Better Alternatives?" *National Tax Journal*, December 2010, vol. 63, no. 4, pt. 2, pp. 1145-1184.

[157] James R. Hines Jr., "Digital Tax Arithmetic," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 119-143.

rights on an MNE's remaining "residual" profit—the excess of its aggregate profits over its total routine earnings (*i.e.*, the rent or supernormal profit of a multinational) across jurisdictions using a sales-based formula. The analyses of residual profit allocations may help provide a general understanding of the economic effects of Pillar One.

One paper explores the implications, conceptual and empirical, of countries moving to some form of residual profit allocation approach.[158] There are three primary findings: (1) the effect on tax revenue appears beneficial for developing countries because of the gain from the reallocation of MNEs' excess profits to developing countries based on sales to those countries; (2) by reducing the ability to shift profits, the residual profit allocation may limit tax competition; and (3) global production efficiency may increase, especially if routine profits are minimally taxed, as destination-based taxation generally leads to fewer distortions in the location of investment as well as MNE ownership decisions.[159]

## C. Economic Effects of Pillar One

Pillar One requires multilateral agreement (at least among a relatively large number of countries) since the proposal involves significant change to the international principles governing the taxation of cross-border income. Pillar One would increase the complexity of the current international tax system, including a complex process for determining the relevant "paying entities" (*i.e.,* MNEs) and a significant and novel multilateral administrative infrastructure (*e.g.,* the review panels required for the tax certainty process). In general, the proposal involves a significant transformation of existing arrangements and practices relating to both tax administration and the prevention and resolution of disputes.

Pillar One may also raise concerns related to tax sovereignty. Pillar One proposes a novel, panel-based, mandatory, binding dispute-prevention process to provide tax certainty, in order to provide a process that includes identifying which countries make the necessary adjustments. The role of most jurisdictions and their parliaments or courts is either nonexistent or reduced to minor aspects, and this lack of legal certainty may raise concerns regarding the way multilateralism is adopted and implemented.[160] Some countries may view this as a loss of their sovereignty, which may make them less likely to support Pillar One.[161]

Pillar One as currently contemplated is relatively narrow in its application, taxing only MNEs with global revenue exceeding €20 billion and profit margins exceeding 10 percent, with exceptions for financial services and extractives industries. Rules for determining the scope of

[158] Sebastian Beer, Ruud De Mooij, Shafik Hebous, Michael Keen, and Li Liu, "Exploring Residual Profit Allocation," *American Economic Journal: Economic Policy*, vol. 15, no. 1, February 2023, pp. 70-109.

[159] *Ibid*.

[160] Ana Paula Dourado, "Would Pillar One Fix the Broken System?" *Intertax*, vol. 51, issue 12, 2023.

[161] Richard Collier, Michael P. Devereux, and John Vella, "Comparing Proposals to Tax Some Profit in the Market Country," *World Tax Journal*, vol. 13, no. 3, September 2021, pp. 405-439.

Pillar One involve trade-offs.[162] On the one hand, restricting the scope of the proposal in any fashion requires policing the boundary between activities that are in scope and out of scope for the purposes of the tax, resulting in possible tax planning around this boundary. On the other hand, broadening the scope requires a wider set of revenue-sourcing rules, which comes with considerable design, implementation, and administration challenges and would increase aggregate compliance and administrative costs for governments and businesses. One article argues that due to its complexity and administrative cost, Pillar One can reasonably be applied only to a relatively small number of businesses, implying the need to restrict its scope by sector, business size, or both.[163] In contrast, other articles argue that applying thresholds to only the largest and most profitable MNEs, while carving out certain MNEs, not only breaches the principle of neutrality[164] but also does not allocate enough revenue to market jurisdictions.[165]

Pillar One introduces sharp discontinuities produced by the revenue and profitability thresholds that determines whether a firm is in scope. Firms just slightly below the size threshold have none of their profits apportioned to Amount A, whereas firms just slightly above have all their residual profits so apportioned. One paper argues that firms can control their own aggregate revenues with mergers, acquisitions, and divestments. As a result, firms just below the Pillar One threshold may distort their behavior to stay below the threshold by not increasing asset ownership and revenue; while firms above the Pillar One threshold may distort their ownership to get below the threshold.[166] Both of these distortive behaviors may reduce firms' productive efficiency.

There may be inefficient incentives for taxpayers and governments that are intrinsic to the sales-based Amount A apportionment method. One paper argues the disconnect between taxing rights assigned by Amount A and taxing rights corresponding to where productive assets are located generates additional distortions even for in-scope firms that expect to remain in scope.[167] Also, highly profitable firms have the incentive to divest any business operations that produce sales in high-tax countries. Moreover, the subset of in-scope firms may have the option to realign their business operations with their counterparties, because all other firms, including most large firms, are not subject to taxation by the Amount A.

[162] For descriptive estimates on the degree to which Pillar One Amount A depends on the companies subject to the proposal, see Michael Devereux and Martin Simmler, "Who Will Pay Amount A?" *EconPol Policy Brief*, vol. 5, no. 36, 2021.

[163] *Ibid*.

[164] Vikram Chand and Camille Vilaseca, "Pillar I: The Marketing and Distribution Safe Harbour (MDSH) as Applicable to Licensed Manufacturers and Centralized Business Models: Does it Fulfill its Policy Objective?" *Intertax,* vol. 51, issue 8/9, 2023, pp. 572-594.

[165] Ana Paula Dourado, "Would Pillar One Fix the Broken System?" *Intertax*, vol. 51, issue 12, 2023.

[166] James R. Hines Jr., "Digital Tax Arithmetic," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 119-143.

[167] *Ibid*.

In general, Pillar One provides a comprehensive approach to dealing with double taxation, but the approach is complex and adds administrative costs. To avoid double taxation, the proposal aims to offset a tax increase in the market jurisdiction with an offsetting adjustment to taxable income elsewhere (*i.e.*, to another element of the business that may possibly be in another jurisdiction). A question then arises as to which elements of the business are likely to see a reduction in their taxable profit to offset the additional profit allocated to the market jurisdiction. If at least a routine rate of return is allocated to each separate entity within the MNE, transfer prices may need to be adjusted in such a way that the reduction in taxable profit must occur in entities to which the residual profit is currently allocated. In this case, the manipulation of transfer prices adds another layer of complexity and administrative costs. This in turn may redirect resources (*e.g.,* labor hours) towards additional tax planning instead of economic or business activity. One article argues for an alternative approach to the Pillar One proposal whereby the new elements of tax introduced should not be creditable against other taxes in order to simplify its implementation.[168]

In regard to Amount B of Pillar One, while there is no need to introduce conceptual novelties to the transfer pricing guidelines, the modification of applying the arm's-length principle with a newly designed pricing matrix implies an increased complexity for MNEs and tax administrations.[169] Similar to the other components of Pillar One, there is a trade-off between certainty and administrability in the proposed Amount B. For example, there are two alternatives for identifying transactions and distributors qualifying for Amount B. Proponents of the first alternative advocate for a simplified, predominately quantitative approach to defining qualification thresholds to facilitate broad adoption of Amount B, while the proponents of the second alternative (generally developing countries) advocate for an additional qualitative scoping criteria to avoid potential tax planning opportunities.[170] A potential compromise includes treating Amount B as a safe harbor, which may help attain a more positive trade-off between required certainty and reliability and desired administrability and simplicity.[171] However, one article argues that if the implementation of Amount B is left to voluntary adoption, its initial purpose of complying with the arm's length principle will be hindered.[172] Along with the other technical components of the proposed Amount B (*e.g.,* the Berry ratio collar, documentation requirements), a decision or compromise remains to be determined.

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[168] *Ibid.*

[169] For a summary of the comments submitted to the Public Consultation Document on Amount B of Pillar One from July 2023 (OECD (July 2023) *Public Consultation Document: Pillar One — Amount B*, OECD Paris https://www.oecd.org/tax/beps/public-consultation-document-pillar-one-amount-b-2023.pdf.), see Oliver Treidler, "A Global Conversation on the Amount B Discussion Draft," *Tax Notes International*, vol. 112, October 2023.

[170] Suranjali Tandon and Chetan Rao, "An Amount B for Developing Countries," *Tax Notes International*, vol. 112, October 2023.

[171] Oliver Treidler, "A Global Conversation on the Amount B Discussion Draft," *Tax Notes International*, vol. 112, October 2023.

[172] Akaoma Osele and Barabara Mbaebie, "Global Tax Reform: An In-Depth Analysis of the Amount B Consultation Document," *Tax Notes International*, vol. 112, October 2023.

Another potential concern with Pillar One is the extent to which overall tax liability may increase as a result of additional market jurisdiction tax and how that potential increase in tax liability may affect future investment decisions. According to standard economic theory, firms will invest in projects only if they are expected to meet a required return on investment (*i.e.,* normal return). Imposing or increasing a tax on the normal return will reduce investment because fewer projects will yield the required return necessary to make an investment attractive. However, a tax on the amount that is in excess of a normal return (*i.e.,* super-normal returns or economic rent) will not reduce investment.[173] By definition, as long as firms make their required return on investment, any tax on economic rent will not prevent the business from meeting its required return. While a tax that falls only on economic rent should be non-distortionary, residual profit, as defined in Pillar One (generally, adjusted profit before tax decreased by 10 percent of revenues), is not economic rent. To the extent that distortions in investment decisions increase with the effective tax rate on returns to those investments,[174] the potential increase in tax resulting from Pillar One could lead to distortions and economic inefficiency.

Methods proposed in Pillar One to determine that amount of residual profit to be taxed by the market jurisdiction are not the same as the methods used to determine where the residual profit is currently taxed. Pillar One is intended to work on the principle that credit should be given against identified residual profit.[175] The rationale behind this approach seems to be that, since the tax base in the market jurisdiction is measured as a fraction of the residual profit, the country receiving the credit should be the country where that residual profit is currently taxed. This rationale for the Pillar One proposal depends on the notion that the income that is reallocated to the market country actually reflects the residual profit. Perhaps, though, taking a fraction of residual profit as reflected in the consolidated group accounts is simply a convenient mechanism for implementing the reallocation of some taxing rights to the market country.

In regard to the marketing and distribution safe harbor (*i.e.*, the MDSH), one article argues that the MDSH as designed in the 2022 Progress Report[176] does not necessarily prevent double taxation under both a licensed manufacturer business model and a centralized business model with limited risk distributors in the market.[177] The authors recommend either

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[173] This statement assumes that super-normal returns or economic rents are taxed in the non-corporate sector as well.

[174] Alan J. Auerbach and Martin Feldstein (eds.), *Handbook of Public Economics,* vol. 4, North-Holland Publishing Co., 2002, pp. 1787-2430.

[175] Richard Collier, Michael P. Devereux, and John Vella, "Comparing Proposals to Tax Some Profit in the Market Country," *World Tax Journal*, vol. 13, no. 3, September 2021, pp. 405-439.

[176] OECD (July 2022) *Progress Report on Amount A of Pillar One*, OECD Paris https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf.

[177] Vikram Chand and Camille Vilaseca, "Pillar I: The Marketing and Distribution Safe Harbour (MDSH) as Applicable to Licensed Manufacturers and Centralized Business Models: Does it Fulfill its Policy Objective?" *Intertax,* vol. 51, issue 8/9, 2023, pp. 572-594. In general, under a licensed manufacturer business model, the parent entity of an MNE is located in Country X and owns the MNE's intellectual property. The parent entity owns subsidiaries in Countries A, B, C, D, and E, which are characterized as local licensed manufacturers. The subsidiaries produce goods under a licensing agreement with the parent entity and sell the goods in their respective

(1) returning to the initial formulaic mechanism as designed in the 2020 Pillar One Blueprint;[178] or (2) simplifying how jurisdictional routine and residual profits are determined. In addition, there is a concern on whether the MDSH should take into account withholding taxes on deductible payments (*e.g.,* royalties). Proponents of including withholding taxes may argue that because withholding taxes also tax residual profits on a gross basis, disregarding them may lead to distortions that does not address the issue of double taxation.[179]

Taxing rights under Pillar One would, in general, be levied on the entity that receives the income, even if those entities are not resident in the market jurisdiction. This may result in challenges, but countries do have experience in collecting tax from non-resident entities with no physical presence within their borders, albeit in more narrowly defined circumstances.[180] Also, Pillar One would, to some extent, look through the direct purchaser to the indirect purchaser or user, who might be less mobile.

Lastly, Pillar One may limit tax avoidance by allocating taxable profit away from entities with little or no economic substance, typically located in tax havens.[181] For example, consider an MNE that has a parent entity in country A and research and development and manufacturing activities in country B, and that holds its intellectual property in tax haven C. Residual profits are located in countries A and C, but not B. Suppose that the profit located in tax haven C represents the result of profit shifting from the other countries. In that case, if Pillar One results in taxable profits being taxed in jurisdictions other than tax haven C, one may argue that the system is less prone to profit shifting. However, given that certain factors of the mechanics of Pillar One have yet to be determined, there could still remain both incentives and opportunities for MNEs to avoid taxes by adjusting their operations and ownership of productive assets.

### D. Implications of Pillar One

Because Pillar One remains under development, there are not yet empirical studies analyzing the economic effects of Pillar One. Therefore, this section largely focuses on

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markets to the final customers. In general, under a centralized business model with limited risk distributors, the parent entity of an MNE is located in Country X and owns subsidiaries in Countries A, B, and C, which are characterized as limited risk distributors ("local entities"). The local entities purchase the finished goods from the parent entity and sell the goods in their respective markets with low risks. Therefore, in the MNE's financial statement, the local entities book an intragroup expense under purchase of goods, and the parent entity registers an income for the intragroup sale of goods to its local entities.

[178] OECD (October 2020) *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, OECD Paris https://www.oecd-ilibrary.org/docserver/beba0634-en.pdf?expires=1708112584&id=id&accname=guest&checksum=02454F220967361EA8952D02D92A9479.

[179] Vikram Chand and Camille Vilaseca, "Pillar I: The Marketing and Distribution Safe Harbour (MDSH) as Applicable to Licensed Manufacturers and Centralized Business Models: Does it Fulfill its Policy Objective?" *Intertax,* vol. 51, issue 8/9, 2023, pp. 572-594.

[180] For example, economic nexus is created when a business has a certain level of economic activity in a jurisdiction, even if it does not have a physical presence there.

[181] *Ibid.*

qualitative discussions and revenue simulations related to the implications of the Pillar One proposal.[182]

Based on the Progress Report on Amount A of Pillar One from July 2022,[183] one working paper uses a variety of databases (*e.g.,* FORBES, ORBIS, OECD AMNE, and OECD CbCR) and presents revenue simulations of Pillar One Amount A from 2016-2020. The paper finds that the global gross revenue potential of Amount A is approximately €15.6 billion when the elimination of double taxation is accounted for.[184] This global net revenue gain is a result of the redistribution of the tax base from low-tax to higher-tax countries where the United States and China collect most of the revenue, given the concentration of MNEs' final consumers in those jurisdictions. In addition, the authors' findings suggest that the current design of Amount A does not necessarily generate more tax revenues than digital service taxes.[185]

When simulating the revenue effects of Pillar One Amount A, the OECD's most recent Economic Impact Assessment ("EIA") shows a significant increase in Amount A revenue estimates compared to the OECD's EIA in 2020. The paper finds annual revenue gains of $9.8 to $22.6 billion on average per year over the years 2017-2021 and $17.4 to $31.7 billion in 2021.[186] This increase reflects not only design changes to Pillar One (*e.g.,* the double tax relief mechanism of Amount A), but also more recent data from MNE-level financial statements.[187] However, these estimates do not take into account any direct or indirect costs of implementing Amount A and a number of provisions associated with Amount A due to data limitations (*e.g.,* the treatment of withholding taxes).

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[182] Note that estimating the effects of Pillar One and Pillar Two independently of each other would overstate the overall gains compared to computing the collective effect of both pillars. The following simulations consider the interaction scenario where Pillar One applies before Pillar Two. This would decrease the possible revenue gains from Pillar Two but does not affect the Pillar One estimates presented.

[183] OECD (July 2022) *Progress Report on Amount A of Pillar One*, OECD Paris https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf.

[184] Mona Barake and Elvin Le Pouhaër, "Tax Revenue from Pillar One Amount A: Country-by-Country Estimates," HALSHS Working Paper 04039288 Version 1, 2023.

[185] *Ibid*.

For additional analysis that provide similar findings by comparing estimates of tax revenues gained between the Pillar One Amount A and Article 12B proposals, see Vladimir Starkov and Alexis Jin, "A Tough Call? Comparing Tax Revenues to be Raised by Developing Countries from the Amount A and the UN Model Treaty Article 12B Regimes," ECONSTOR Research Paper No. 156, South Centre, Geneva, June 2022. Note that the analysis is based on OECD's Statement on a Two-Pillar Solution from July 2021 and relies on data sources that do not involve review of any information that taxpayers provide to tax authorities.

[186] OECD (2023), *Update to the Economic Impact Assessment of Pillar One: OECD/G20 Base Erosion and Profit Shifting Project*, OECD, Paris, available at https://www.oecd-ilibrary.org/docserver/7c35a55c-en.pdf?expires=1708015819&id=id&accname=guest&checksum=A96C5362BDC52DB9F181AE45B72AA1CF.

[187] Note that despite the positive net impact on global corporate tax revenues, the impact of Amount A on the global corporate tax base equals zero.

# IV. ECONOMIC ANALYSIS OF PILLAR ONE AMOUNT A

In this section the Joint Committee staff estimates the effect of a broad worldwide adoption of Pillar One Amount A on U.S. Federal receipts. The Joint Committee staff used data from financial reporting,[188] tax returns,[189] and country-by-country reports combined with a variety of jurisdiction-level economic data to estimate the effect on U.S. Federal income tax receipts. The analysis involves five steps: (1) determining which MNEs are in scope for purposes of Pillar One, (2) calculating Amount A for each in-scope MNE, (3) estimating jurisdiction-level reallocation of profits, (4) estimating for each MNE its jurisdiction-level marketing and distribution safe harbor (*i.e.*, the MDSH), and (5) calculating the direct and indirect effects of reallocation on U.S. Federal income tax receipts.

Estimating the effect of Pillar One on U.S. Federal receipts is complex and uncertain. Pillar One relies on financial reporting to determine those jurisdictions receiving excess profits, those jurisdictions required to offer relief, and jurisdiction-specific liability. However, existing reporting regimes presently provide insufficient information for generating precise revenue estimates, and individual companies may have substantial leeway in reporting the financial information that ultimately determines any reallocation under Pillar One.

Below, the Joint Committee staff describes the methods and data used to determine a range of possible effects of Pillar One on U.S. Federal receipts had the proposal been in effect in 2021. The Joint Committee staff estimates that the single-year effect of Pillar One, had it been in effect in 2021, would have been a loss in U.S. Federal receipts of $1.4 billion. The Joint Committee staff also present a range of single-year effects, from a loss of $100 million to a loss of $4.4 billion reflecting different methods of determining the amount of final sales in the United States for in-scope MNEs. This range reflects the high degree of uncertainty about many aspects of the implementation of Pillar One, including the use of allocation keys to assign final sales to jurisdictions, the degree of available data on exports and imports for the United States, the application of the MDSH, and the degree to which the IRS can effectively administer the provisions.

Estimating the effect of Pillar One on U.S. Federal receipts faces four major sources of uncertainty: (1) uncertainty with respect to the sourcing of sales, (2) uncertainty from lack of data necessary for underlying calculations, (3) uncertainty with respect to the potential response of MNEs, and (4) uncertainty from interactions with jurisdictional corporate income tax rules and the implementation of Pillar Two. First, data on the destination of sales by MNEs is generally unavailable. Any estimate of the reallocation of profits must follow an imputation based on existing financial, tax, and macroeconomic data. Second, new concepts governing, for example, scoping parameters and the determination of Amount A are not identical to currently reported financial or tax concepts. For example, to estimate the effect of Pillar One adoption on U.S. Federal receipts, it is necessary to first estimate Amount A. Third, the response to Pillar

[188] For example, Forms 10-K filed with the Securities and Exchange Commission.

[189] For example, Forms 1120 ("U.S. Corporate Income Tax Return"), Forms 8975 ("Country by Country Report"), and Forms 8993 ("Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)").

One by MNEs in terms of the location of sales and profits is highly uncertain. Fourth, many jurisdictions have begun to implement components of Pillar Two. Under Pillar Two, domestic MNEs are incentivized to report profits in the United States and jurisdictions compliant with Pillar Two, but the degree to which these changes will be realized is uncertain.[190] Where profits are reported affects both the amount of foreign taxes allowed as credits in the United States as well as the reallocation of profits under Pillar One Amount A.

The analysis in this section relies on data from 2021 and, as such, is meant to give a sense of the range of revenue effects had Pillar One been in place in that year. This analysis does not reflect any interactions with the corporate alternative minimum tax, which was enacted in 2022. Similarly, for purposes of this exercise, focusing on 2021 means that the following analysis does not consider interactions with Pillar Two, as no countries had adopted Pillar Two as of that year. Implementation of Pillar Two would likely lead to a change in tax rates across jurisdictions and, most likely, a reallocation of profits and sales which would result in direct and indirect effects on the revenue collected under Pillar One Amount A. The current Joint Committee staff analysis is restricted to 2021 and does not account for these possible effects.

## A. Scoping

The first step to estimating the revenue effects of Pillar One adoption is to determine which entities would be subject to the rules (*i.e.*, "in scope"). The scoping rules described earlier in this document include multi-year revenue and profitability tests and special exceptions for firms in certain industries. The Joint Committee staff used publicly available annual financial reporting data, country-by-country reporting, and other company-specific information to identify the set of companies that would have been in-scope for the purposes of Pillar One based on their characteristics in 2021. The Joint Committee staff identified 53 foreign MNEs and 47 domestic MNEs that are in scope. In addition, the Joint Committee staff identified 11 segments that are in scope: six foreign and five domestic.

Generally, consolidated financial reporting data provides a reasonable estimation of which companies would be in scope. However, existing data presents several challenges. First, financial reporting data is largely only available for publicly traded MNEs. As a result, determining which privately held MNEs might be in scope is difficult. Second, determining whether a MNE or a segment of the MNE is excluded as either a regulated financial institution or a qualifying extractive group or segment is uncertain. As a result, there could be some MNEs or segments that are included (or excluded) that should have been excluded (or included).

## B. Amount A

Once a MNE is determined to be in scope, the Joint Committee staff uses company worldwide financial reporting data to estimate the Amount A that is potentially reallocated.

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[190] Foreign MNEs are also incentivized to report profits in Pillar Two compliant jurisdictions. For a description of Joint Committee staff's methodology for estimating the effects of Pillar Two, see Joint Committee on Taxation, *Possible Effects of Adopting the OECD's Pillar Two, Both Worldwide and in the United States*, June 2023 for discussion about the possible effects of Pillar Two. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

Amount A for a given company $i$ ($AA_i$) is equal to 25 percent of the MNE's adjusted profits ($AP_i$) in excess of 10 percent of adjusted revenues ($AR_i$).

$$AA_i = 0.25*(AP_i - (0.1* AR_i))$$

The Joint Committee staff calculates Amount A for each in-scope MNE using a combination of financial reporting data and tax data. When possible, the Joint Committee staff estimates adjusted profit by accounting for income taxes, dividends, distributions, and gain or loss with respect to equity interest. The Joint Committee staff estimates that there is $193 billion of Amount A for the in-scope MNEs in 2021, of which $135 billion is derived from domestic MNEs (*i.e.*, those with a domestic ultimate parent entity).

### C. Identifying Market Jurisdictions and Allocating Excess Profits

The next step involves estimating the jurisdictions in which customers consume or use the good or service underlying the MNE's revenue. Amount A is allocated based on each jurisdiction's share of reliably sourced sales, making this measure fundamental to understanding the effects of Pillar One. When MNEs cannot reliably identify the final destination of the sale of their product, a number of allocation keys are used to approximate the final destination. Ideally, MNEs would know the location $j$ of their final sales and could calculate an MNE-level and jurisdictional specific allocation key ($AK_{i,j}$) based on sales in that jurisdiction ($S_{i,j}$) divided by total worldwide revenues or sales ($WWS_i$).

$$AK_{i,j} = \frac{S_{i,j}}{WWS_i}$$

This step involves a substantial amount of uncertainty given available data, and individual MNEs are likely to have considerable leeway in determining these amounts. Additionally, as indicated in some of the comment letters from MNEs that are likely to be in-scope, identifying the final destination of the sales of products is not trivial for them.[191]

In the case of modeling Pillar One generally, the challenges of sourcing revenues are compounded when using financial or tax records to estimate the share of final sales in each jurisdiction. Financial reporting data provides some detail on geographical segments, but this is largely voluntary and insufficiently specific to jurisdictions. Country-by-country reports provide information on unrelated party revenues by jurisdiction. However, this information is not reported on a destination-basis and, thus, includes sales from one jurisdiction to an unrelated party in another jurisdiction. As a result, it is not entirely suitable for use in the creation of allocation keys for the purposes of the Pillar One estimation. For example, unrelated party income reported in the United States on country-by-country reports for a domestic MNE might include sales to third parties in Mexico, thereby overstating the MNE's U.S. final sales for purposes of Pillar One. At the same time, the country-by-country reports do not include unrelated party sales from Mexico into the United States, thereby understating U.S. sales for

[191] As described in the section on comment letters, stakeholders expressed concern with the proposed allocation keys when companies do not have adequate final sales data suggesting that the allocation keys are arbitrary.

purposes of Pillar One. The Joint Committee staff undertook a number of sensitivity analyses on the use of macroeconomic aggregates to allocate sales to jurisdictions to help determine a reasonable range of effects. The methods behind a number of those sensitivity analyses are discussed briefly below.

One option is to adjust unrelated revenues based on jurisdiction-level characteristics (*e.g.*, share of global GDP) under the assumption that sales are correlated with those measures. To do this, the Joint Committee staff created several firm-specific allocation keys based on the firm's global distribution of unrelated revenues and macroeconomic aggregates related to the type of business (*e.g.*, consumption data is used for firms primarily engaged in production or sale of consumer products). The Joint Committee staff use four different macroeconomic aggregates (GDP, consumption, internet usage, and tobacco usage), in addition to global and regional distributions of reported revenues, to estimate the allocation of sales across jurisdictions. The Joint Committee staff create a proxy for the sales share, $AK_{i,j}$, with macroeconomic aggregate jurisdictional shares. For example, in the case of MNEs the Joint Committee staff designates as focusing on consumer products, the Joint Committee staff uses the jurisdictional share of final consumption to reallocate unrelated revenue between jurisdictions. The intent of this adjustment is to more accurately represent the location of final sales. In the simulations presented below, this adjustment occurs at a regional level.

Another potential data source useful in disentangling these cross-jurisdiction sales is Form 8993, "Section 250 Deduction for Foreign Derived Intangible Income (FDII) and Global Intangible Low Taxed Income (GILTI)," which provides some information on sales to foreign jurisdictions. However, for the purpose of estimating the effect of Pillar One, this data is also imprecise because of differences in the consolidation of the group for tax purposes, financial reporting, and country-by-country reporting.

Despite these inconsistencies, the Joint Committee staff use the Form 8993 data to address exports in the sensitivity analysis. For in-scope domestic MNEs, the Joint Committee staff estimates that the average U.S. share of worldwide sales is 45 percent after adjusting for exports using the Form 8993 data. This share, which excludes direct sales of imported goods, likely understates U.S. sales. While there is not analogous data for adjusting imports on a company-by-company basis, the Joint Committee staff performed simulations to adjust the share of final sales in the United States upwards to account for imports. These adjustments still resulted in some MNEs displaying implausibly low final sales in the United States. The Joint Committee staff implemented a floor on the final sales in the United States equal to the U.S. share of worldwide GDP. These two adjustments increase the average U.S. share of worldwide sales for in-scope domestic MNEs to 54 percent.

### D. Marketing and Distribution Safe Harbor

Before the allocation keys are applied to Amount A, MNEs are allowed to apply the MDSH, which reduces Amount A in the jurisdiction. Generally, the MDSH allows a return on depreciation and payroll within a jurisdiction based on the MNE's worldwide return on depreciation and payroll or a three percent return on sales. This allowance is scaled by the jurisdictional offset percentage ("JOP") of 35 percent for high-income jurisdictions, 25 percent

for low- and low-middle income jurisdictions,[192] and 90 percent for low-depreciation and payroll jurisdictions. The MDSH is designed to provide relief to jurisdictions with a significant amount of reported profits. To estimate the necessary parameters for calculating jurisdiction-level MDSH, the Joint Committee staff relied on data on depreciation and employment from financial reporting, country-by-country reporting, and tax returns in combination with jurisdiction-level data on wages.

$$MDSH_{i,j} = \min(AA_{i,j}\ ,\ [AP_{i,j} - \max\left(0.03 * S_{i,j}, ELTRDP_i * DP_{i,j}\right)] * JOP_{i,j})$$

For companies in jurisdiction $j$ with adjusted elimination profits in excess of €50 million, the MDSH is the minimum of (1) the amount A for company $i$, in jurisdiction $j$ ($AA_{i,j}$), and (2) adjusted elimination profit for company $i$ in jurisdiction $j$ ($AP_{i,j}$) less the maximum of a three percent return on sales in the jurisdiction or the worldwide elimination threshold return on depreciation and payroll ($ELTRDP_i$) multiplied by depreciation and payroll for firm $i$ in jurisdiction $j$ ($DP_{i,j}$), multiplied by the jurisdictional offset percentage ($JOP_{i,j}$).

The elimination threshold return on depreciation and payroll is designed to apply a company-wide return on depreciation and payroll to the amount of depreciation and payroll in the jurisdiction.

$$ELTRDP_i = 0.1 * WWS_i / WWDepandPay_i$$

The elimination threshold return on depreciation and payroll is 10 percent of worldwide sales ($WWS_i$) divided by worldwide depreciation on tangible assets and payroll ($WWDepandPay_i$). To estimate the necessary parameters for calculating jurisdiction-level MDSH, the Joint Committee staff relied on data on depreciation and employment from financial reporting, country-by-country reporting, and tax returns in combination with jurisdiction-level data on wages.[193]

Incorporating the MDSH, the reallocation amount for a company in a jurisdiction ($RA_{i,j}$) is amount A multiplied by the allocation key for that company ($AK_{i,j}$) in that jurisdiction less the MDSH:

$$RA_{i,j} = AA_i * AK_{i,j} - MDSH_{i,j}$$

### E. Elimination of Double Taxation

The sum of the reallocation amounts across jurisdictions represents the total amount of reallocations to market jurisdictions for each MNE, $TRA_i$. To avoid two jurisdictions taxing the same profits, certain jurisdictions are required to offer relief of double taxation by ceding taxing

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[192] This determination relies on income classifications using the World Bank's GNI Atlas method, as described in the MLC.

[193] Jurisdictional wages are calculated as the CbCR reported number of employees in a jurisdiction multiplied by the jurisdiction's average wage rate, as reported by the International Labor Organization. The data can be found at: https://ilostat.ilo.org/topics/wages/.

rights over a portion of reported profits. Pillar One has specified a "waterfall" method for determining relieving jurisdictions and amounts by which taxing rights are first relinquished by jurisdictions with high returns on depreciation and payroll. In effect, jurisdictions with either high reported profits or very low depreciation and payroll in that jurisdiction cede their taxing authority on a portion of reported profits. The relief amount for a given jurisdiction ($REL_{i,j}$) is the minimum of the adjusted elimination profit for company *i* in jurisdiction $j$ ($AP_{i,j}$), bounded from below at zero, and the total amount of reallocations to market jurisdictions for each company ($TRA_i$):

$$REL_{i,j} = \min\left(\max\left(0,\ AP_{i,j}\right), TRA_i\right)$$

**U.S. Federal Tax Consequences**

U.S. Federal tax consequences for a given company ($US_Revenue_i$) from implementation of Pillar One are summarized by the following equation for company *i*:

$$US_Revenue_i = US\ Tax\ Rate * \left(RA_{i,US} - REL_{i,US}\right) - \sum_{j \neq US} \Delta FTC_{i,j}$$

U.S. Federal revenue effects are the difference between allocations to the United States ($RA_{i,US}$) and amounts relieved by the United States ($REL_{i,US}$) multiplied by the U.S. tax rate less the change in allowed foreign tax credits for company *i* ($\Delta FTC_{i,j}$) summed across all foreign jurisdictions. Reallocations in excess (less than) of relieved amounts would result in a direct revenue gain (loss).

### F. Potential Pillar One Revenue Effects

The Joint Committee staff estimates that enactment of Pillar One Amount A results in a revenue loss of $1.4 billion had it been in effect in 2021. Additionally, the Joint Committee staff presents a range of results. As discussed above, there are significant uncertainties with estimating the revenue effects of Pillar One. The Joint Committee staff estimates three different revenue effects under three different sets of assumptions. The first simulation uses only unrelated revenue to source sales in the United States. The second simulation adjusts U.S. unrelated revenues for exports observed on tax returns. Finally, the third simulation, in addition to adjusting U.S. unrelated revenues for exports (as in the second simulation), adjusts U.S. unrelated revenues to account for imports. All three simulations use a combination of firm specific allocation keys and regional totals of unrelated income to source sales outside the United States.[194] These simulations are not presented in any specific order.

Simulation 1. The first simulation uses unrelated revenue as reported to taxing authorities on the country-by-country reports combined with financial reporting data to approximate where sales are located. In this simulation, step one is to approximate final sales in the United States by unrelated revenues as reported on country-by-country reports. Next, foreign

[194] First, final sales in the United States are calculated and removed from worldwide sales. Foreign sales are then distributed across regions based on the region's share of unrelated revenues. Regional sales are then distributed to each jurisdiction within the region based on the firm specific allocation key.

sales are calculated as the residual after excluding final sales in the United States in step one and are allocated using firm specific regional and jurisdictional allocation keys. This simulation results in an estimated single-year loss in U.S. Federal receipts of $100 million. As discussed, using unrelated revenues as reported on country-by-country reports to proxy for total sales as sourced under Pillar One is problematic because they do not realistically represent final sales in the country. They do not exclude exports from the United States, and they do not include direct sales from foreign parties into the United States.

Simulation 2. The second simulation adjusts U.S. unrelated revenues for sales eligible for the FDII deduction (as observed on Form 8993) and uses firm-specific regional and jurisdictional allocation keys to source revenues reported outside the United States. The Joint Committee staff estimates a single-year effect that, under these assumptions, Pillar One reduces U.S. Federal receipts by $4.4 billion. This simulation is potentially unrealistic with respect to U.S. revenues as it assumes that resourcing the sales of U.S. exports will occur while the resourcing of U.S. imports will not.

Simulation 3. The final simulation adjusts unrelated revenues for sales eligible for the FDII deduction (as in the second simulation) and adjusts U.S. sales to account for imports. The adjustment for imports first increases the calculated U.S. share of sales on a company-by-company basis. Then the adjustment imposes a lower bound on the U.S. share of worldwide sales on a company-by-company basis equal to the U.S. share of worldwide GDP.[195] As in simulation 2, this simulation uses a combination of firm-specific regional and jurisdictional allocation keys to source revenues reported outside the United States. The net revenue effect of Pillar One adoption in this simulation is a reduction in single-year U.S. Federal receipts of $1.4 billion. Because simulation 3 is more careful with respect to the treatment of exports and imports, simulation 3 is the Joint Committee staff's preferred estimate of the effects of Pillar One Amount A.

These three simulations highlight the sensitivity of estimates to different methods of estimating the share of sales sourced to the United States. In each of the simulations, foreign MNEs contribute positive revenue to the United States as a result of Pillar One Amount A, and domestic MNEs generate losses for the United States. Losses for domestic MNEs are a combination of both the direct effect of reallocations outside of the United States and indirectly through increased foreign tax credits. The change in foreign tax credits generally make up about a third of the domestic losses due to reallocations from low-tax foreign jurisdictions to higher-tax foreign jurisdictions. Additionally, application of the MDSH substantially reduces reallocations to the United States in aggregate, leading to lower revenues than otherwise. These three simulations focus on the uncertainty surrounding sales-sourcing under Pillar One, but as discussed, there are a number of other sources of uncertainty surrounding scoping, calculations using financial data, and behavior, which also are considered by the Joint Committee staff in formulating these estimates. These estimates are preliminary and subject to change as the Joint Committee staff learn about possible behavioral responses, the proposal is clarified, and new data becomes available.

[195] This lower bound affected a minority of the companies in scope.