New York State Bar Association
2021 Annual Meeting Tax Section

Tuesday, January 26, 2021

International Tax? Moving from a U.S.-Centric to a Truly International System of Tax Rules

Peter H. Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Tijana J. Dvornic
Wachtell, Lipton, Rosen & Katz

Paul W. Oosterhuis
Skadden, Arps, Slate, Meagher & Flom LLP

Gary Scanlon
KPMG

Kimberly S. Blanchard, Panel Chair
Weil, Gotshal & Manges LLP

OECD Work on the Digital Economy

Pillar One

- Intended to address perceived tax challenges arising with increased globalization and digitalization
  - Businesses in the digitized economy are able to access and actively participate in markets where they have little or no physical presence…
  - …but established international tax systems and rules generally afford taxing rights based primarily on physical presence
- Pillar One seeks to adapt the international income tax system to new business models through changes to the profit allocation and nexus rules applicable to business profits
- Expands taxing rights of "market jurisdictions" (generally, where the users are located) where there is an active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction
- Dramatic paradigm shift from existing rules, particularly as relates to nexus, sourcing and transfer pricing

Pillar One: Amount A

- Allocation of taxing rights to market jurisdictions using formulaic approach
- Scope
  - Automated Digital Services businesses (“ADS”)
  - Consumer-Facing Businesses (“CFB”)
- Threshold Tests
  - Global Revenue Test (€750MM country-by-country)
  - De Minimis Foreign In-Scope Revenue Test (€250MM)
- Nexus
  - ADS: Established merely by exceeding market revenue thresholds per year
  - CFB: Higher standard; market + significant and sustained physical engagement in the market jurisdiction beyond mere sales (“plus factor”)
- Revenue Sourcing – Rule hierarchy based on ADS/CFB and business model
- Tax Base – Group-wide profits from financial statements (GAAP, IFRS)

Pillar One: Amount A

- Reallocates “non-routine” profits
  - Calculated as profits in excess of a pre-determined percentage, by reference to financial statement PBT
- A portion of such non-routine profit is then potentially allocated to market jurisdictions, again based on pre-determined reallocation percentage
- Allocation among market jurisdictions
  - Determined based on revised nexus rules
  - Generally allocated based on in-scope revenue
- Amount A is expressly designed to move away from arm’s-length principles and physical presence requirements
- Similar to recent shift in U.S. state taxation
  - Impact of the *Wayfair* decision; vast majority of states now apply some type of economic nexus standard

Pillar One: Amount B

- Creates a set return under current arm's-length principles for certain marketing and distribution activities with respect to related party distributors
- Created to simplify transfer pricing administration, reduce compliance costs, increase tax certainty, and reduce controversies
- Not subject to Amount A threshold tests, generally uses current nexus principles. Positive and negative lists will dictate the scope of activities
- Because Amount B is relatively similar to existing rules and is anticipated to be relatively limited in scope, it is less controversial than Amount A

Pillar One and Proposed Regulations Revising the Definition of a Creditable Income Tax Under Sections 901 and 903

Preamble Overview of Revisions to Reg. §1.901-2 and Reg. § 1.903-1

- Incorporate "international norms," as "reflected" in IRC, regarding jurisdiction to tax for both net income taxes and taxes in lieu of income taxes
- Resolve issues and "clarify" other rules defining a creditable income tax and an in lieu of tax, and determining the amount of tax paid. Substantial changes are made to:
  - Requirements to determine net gain
  - Definition of a separate levy
  - Treatment of credits against foreign income tax
  - Definition of non-compulsory payments

New Jurisdictional Nexus Requirements (Prop. Reg. § 1.901-2(c))

Preamble

- Addresses "a variety of novel extra-territorial taxes that diverge…from traditional norms…as reflected in the Internal Revenue Code."
- Notes that if U.S. accepts changes in norms (e.g. OECD pillar 1), regulations could be revised
- Does not apply to "covered taxes" under income tax treaties

Application to Non-Resident Taxes:

- Only creditable if based on in-country functions and activities (similar to Code effectively connected or treaty PE rules)
- Based on source rules "reasonably similar" to U.S. source rules
- For sales of property, based on real property located in country or movable property connected to in-country business or PE

Impact of Requirements

- Tax on services only creditable in country of "performance"
- Tax imposed on non-resident sale of stock unconnected with local trade or business not creditable

New Jurisdictional Nexus Requirements (cont'd)

Examples of Foreign Taxes Made Non-Creditable (where not covered by treaty):

- Indian tax on non-Indian services
- U.K. diverted profits tax on non-U.K. corporations
- China bulletin 7 tax
- Puerto Rico tax on affiliated non-local purchasers

New Jurisdictional Nexus Requirements

<u>Application of Requirements to Resident Taxpayers</u>

- Income subject to tax must be determined based on “arms length principles” as applicable under section 482 and OECD transfer pricing guidelines
- Specifically rejects taking into account “as a significant factor” the location of customers or users

<u>Impact of Requirements</u>

- Taxes imposed based on formulaic income allocations not creditable
- Allocation of income to market-based intangibles (e.g. customer base) and local goodwill potentially ignored

<u>Examples of Foreign Taxes Made Non-Creditable</u>

- Brazil and other country fixed margin transfer pricing
- U.K. diverted profits tax on U.K. resident entities

New Jurisdictional Nexus Requirements

Application of Requirements to in Lieu of Taxes

- Section 903 tax in lieu of income tax limited to taxes that would have met the jurisdictional nexus requirements were they imposed on net income

Impact of Requirements

- Taxpayers cannot argue Section 903 credit for taxes that fail Reg § 1.901-2(c) jurisdictional requirements
- Source rules for withholding taxes must be “reasonably consistent” with U.S. rules

Examples of Foreign Taxes Made Non-Creditable

- Puerto Rico excise tax
- Indian equalization levy

New Jurisdictional Nexus Requirements Questions Raised by New Requirements

How broad is Treasury's authority to deny credits for true net income taxes solely based on a lack of jurisdictional nexus?

From a policy perspective, are issues of jurisdictional nexus best dealt with by defining creditable taxes or through application of the foreign tax credit limitation? For example, would a per country limitation adequately deal with these concerns?

If covered taxes under income tax treaties are not affected, should regulations also treat such taxes as creditable when imposed outside the scope of tax treaties?

- For example, U.S. China treaty permits Chinese taxation of non-resident sale of China company stock if own 25% or more. Should that tax only be creditable if seller is a U.S. resident (as opposed to, for example, a CFC of a U.S. resident)?

Other Proposed Reg. § 1.901-2 Changes

<u>Net Gain Requirement</u>

Remains based on realization, gross receipts and allowance of deductions (renamed “costrecovery”) requirements

Replaces overall “predominant character” standard with an imbedded “insignificance” standard

- Realization exceptions must be “relatively insignificant”
- Imputed gross receipts “likely to be less” than fair market value no longer meet gross receipts test
- All “significant” costs relative to total costs must be deductible
  - Cost-plus headquarters example reversed
  - Formulaic deductions not taken into account unless always equal or exceed actual costs
  - Gross basis taxes now never satisfy the cost recovery requirement
  - Payroll taxes creditable only if employee expenses deductible

Other Proposed Reg. § 1.901-2 Changes

Separate Levy Rules Expanded (to permit more targeted credit disallowance)

- Non-resident taxes always a separate levy from resident taxes
- Withholding taxes are separate levies for each class of gross income

Amount of Tax Paid

- Reduced by refundable (as well as non-refundable) credits
- Preamble requests comments on economic development-type grants if tied to income

Non-Compulsory Payments

- Withdrawal of 2007 proposed regulations
- Requires specific taxpayer to minimize foreign income tax over time
  - Impacts elections between creditable income taxes and other taxes
  - Elections that permanently increase income tax not allowed unless relate to choice of entity, consolidated reporting, or loss surrender

Other Proposed Reg. § 1.901-2 Changes

Retains requirements that a tax be in substitution of an income tax generally imposed

Tightens Standard for Substitution

- Must not be duplicative in any respect for any person subject to the tax (e.g. revenue-based tax imposed on both non-residents and residents must be substitution for both)
- Must have a “close connection” to the generally imposed income tax through explicit statutory exception, legislative history, etc.
- If had been a net income tax, would have met jurisdictional nexus requirements

Exception for “Covered” Withholding Taxes

- Same no duplication requirement
- Identity of payor/legally liable party irrelevant
- Source rules must be similar to U.S. rules

Pillar Two and GILTI

Potential Biden International Tax Agenda

—Double tax rate on GILTI from 10.5% to 21%, while increasing general corporate rate to 28%

—Modify GILTI by eliminating the exemption for QBAI and changing from global to country-by-country "high tax" determination

- Repeal of the GILTI high-tax exception?

—Impose 15% "minimum book tax" on corporations with book profits of $100 million or higher and 10% surtax on "round-tripping"

- But also 10% "Made in America" tax credit for investing in facilitates and job in the U.S.

Background of OECD Work on Pillar Two

The OECD and the Inclusive Framework have developed a two pillar approach to addressing the tax challenges presented by the digital economy

— Pillar One addresses nexus and profit allocation and seeks to expand the taxing rights of market/user jurisdictions, and improve tax certainty through dispute prevention and resolution measures

— Pillar Two seeks to address the remaining BEPS challenges linked to the digital economy by proposing rules designed to ensure that large multinational businesses pay a minimum level of tax, regardless of where they are headquartered or where they operate

Pillar Two proposes to introduce rules that would provide jurisdictions with additional taxing rights where other jurisdictions have not exercised their primary taxing rights or the relevant income is otherwise subject to a low effective tax rate ("ETR")

— Under Pillar Two jurisdictions remain free to determine their own tax system, including whether they have a corporate income tax and where they set their tax rates, but other jurisdictions have the right to apply the new rules where income is taxed at an ETR below a minimum rate

Overview of the Pillar Two Blueprint

1. Subject to Tax Rule (STTR)

a) Pay withholding tax – Payor jurisdiction denies treaty benefits for intragroup payments of interest, royalties, and fees for certain intermediary services (e.g., marketing, procurement, agency) that are subject to low nominal rate of tax to top-up to agreed rate

2. Global Anti-Base Erosion (GloBE) Rules

b) Calculate GloBE tax – Determine applicable MNE group and its constituent entities, compute their "covered taxes" and tax base to ascertain ETR on a jurisdictional basis, then compute amount of top-up tax ("GloBE tax") necessary to obtain min rate

c) Apply income inclusion rule (IIR) – Parent pays GloBE tax with respect to constituent entities

d) Apply switch-over rule (SOR) – The head office jurisdiction overrides PE exemption under treaty to apply GloBE tax to income of PEs

e) Apply under-taxed payments rule (UTPR) – Allocate GloBE tax of constituent entities not subject to an IIR to other constituent entities that make otherwise deductible payments to such group entity, based on relative amount of group payments made

The Future of Pillar Two

What has to happen for political agreement?

— GILTI must be treated as a qualifying IIR (“GILTI co-existence”)

— OECD “strongly encourages” that the U.S. turn off the BEAT with respect to payments to entities subject to the IIR. Necessary? Can it be accomplished by regulation, or is legislation required?

— Are Pillar One and Pillar Two a “package deal”?

What happens if there is political agreement?

— STTR and SOR require changes to bilateral treaties; can the U.S. ratify changes?

— Payments between CFCs of US MNE can still be subject to STTR even if GILTI is qualified IIR

What happens if there are is no political agreement?

— Countries may enact their own GloBE rules; Blueprint claims that IIR and UTPR can be implemented through domestic legislation without violating treaties

Comparison of GloBE and GILTI

	GloBE	GILTI
Rate	~10%[1]	10.5-13.125%[2]
In-scope entities	MNEs with annual revenue over €750m, with exclusions[3]	US shareholders of CFCs
ETR computation	Jurisdictional	Global
Accounting standard	Financial accounting standard, with some adjustments for book-tax differences[4]	U.S. tax
Carryovers	Loss and excess taxes	None
Normal return basis	Tangible asset and payroll	Tangible asset

[1] From examples in the Pillar 2 Blueprint; still to be determined
[2] Variable because of 80% haircut to foreign tax credits; also, subject to application of foreign tax credit limitation
[3] Excluded entities are investment funds, pension funds, governmental entities (including sovereign wealth funds), and international and non-profit organizations.
[4] Adjustments include including deduction for stock-based comp (to the extent deductible under local law), including portfolio dividends, excluding intragroup dividends, excluding gains or losses from stock disposition, taking into account the effect of immediate expensing / accelerated depreciation. Also, while buyers of stock must generally use historical asset basis, there is an exception for same country sale treated as asset sale (e.g., under §338(h)(10)).

Importance of GILTI Co-existence

Under top-down approach, an IIR imposed in an intermediate jurisdiction must defer to an IIR imposed in jurisdiction of ultimate parent entity (UPE)

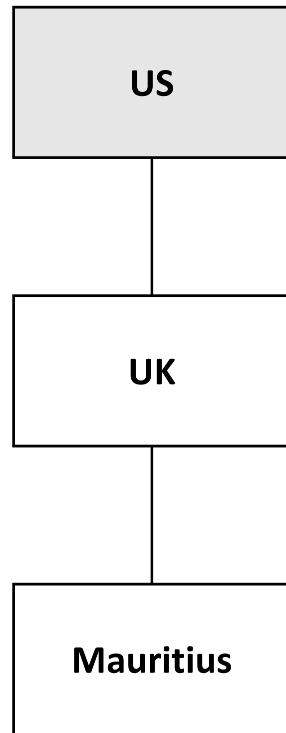
For US-parented group, if GILTI is a qualified IIR…

- CFCs of US MNE will not be subject to multiple IIRs
- No CFC of a US MNE will be subject to UTPR, but US entities of US MNE could be subject to UTPR

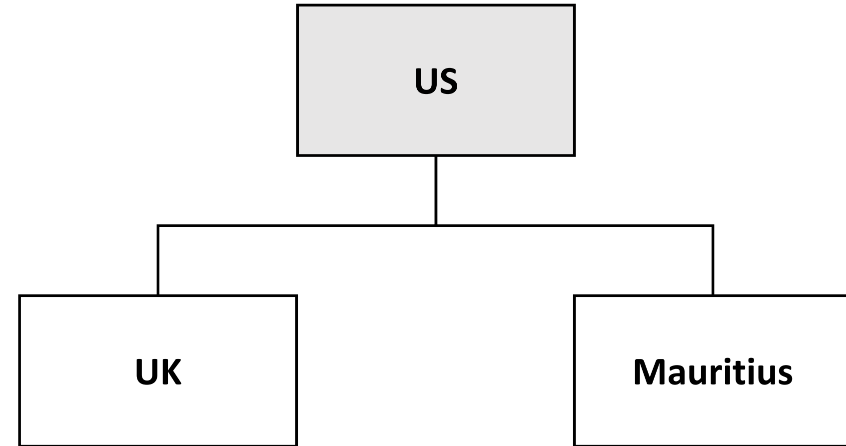
For US-parented group, if GILTI is not a qualified IIR…

- CFCs of US MNE could be subject to multiple IIRs
- CFCs of MNE may be subject to UTPR of other jurisdictions
- Will taxes be creditable in the US as tested taxes?

Lack of GILTI Co-existence



- UK and Mauritius are subject to GILTI
- Mauritius could also be subject to UK's IIR



- UK and Mauritius subject to GILTI
- Mauritius could also be subject to UK's UTPR

GILTI Co-existence Is Not a Cure-all

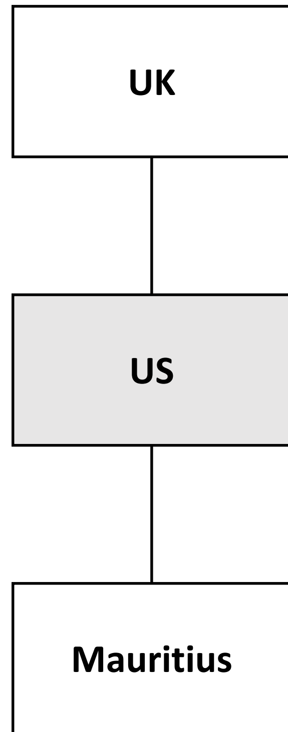
If US is intermediate entity, even if GILTI is a qualified IIR…

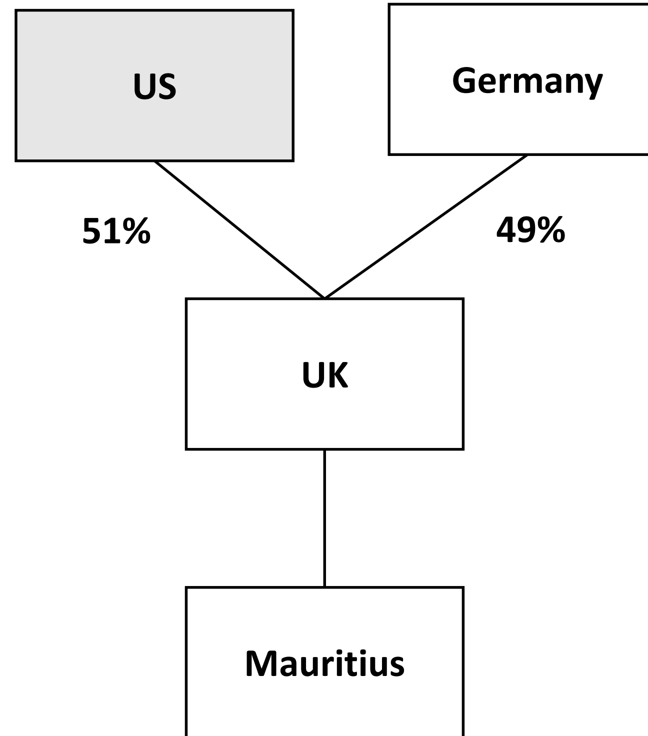
- Potential conflict between GILTI and IIR of UPE jurisdiction with respect to lower-tier CFCs
- Income of US MNE potentially subject to IIR of UPE jurisdiction or UTPR of affiliates if US viewed as low-taxed due to book-tax differences (e.g., in the case of financial services, insurance and extractives companies)

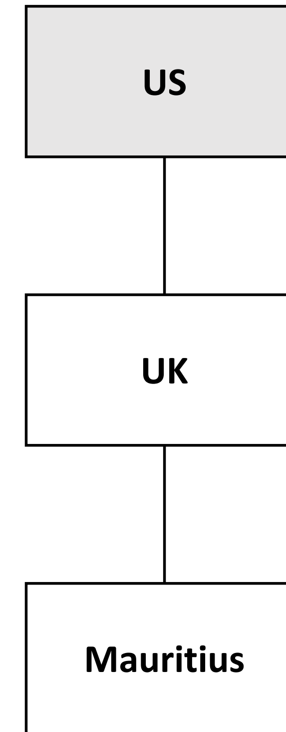
If US is ultimate parent entity, even if GILTI is a qualified IIR…

- No deference by intermediate jurisdiction in cases of "spilt ownership," where a significant portion (e.g., 10% or more) of the interests in intermediate entity are owned by persons not in MNE group
- STTR may be imposed on payments between non-US subsidiaries of US parent
- UTPR may be imposed on income of US parent from non-US subsidiaries if US viewed as low-taxed due to book-tax differences (e.g., in the case of financial services, insurance, and extractives companies)

Even with GILTI Co-existence







- Mauritius subject to GILTI
- US and Mauritius subject to UK's IIR

- UK and Mauritius subject to GILTI
- Mauritius subject to UK's IIR
- UK and Mauritius not subject to Germany's IIR

- UK and Mauritius not subject to IIR or UTPR
- But US could be subject to UK's UTPR

Potential U.S. Responses to Pillar Two

—Modifying GILTI to conform to Pillar Two

—Adopting domestic minimum tax to avoid application of UTPR to US entities

—Adopting UPTR in exchange for eliminating BEAT

MCLE Verification Code

T

What Would We Need to Change?

Pillar One Implementation: Generally

- Pillar One intended as an overlay on top of existing taxing regimes, but requires domestic adoption
- The Blueprint contemplates the following domestic law changes:
  - New taxing rights consistent with Amount A
  - Relief from double taxation
  - Procedures to support new taxing rights and relief from double taxation and
  - Administrative changes, such as dispute prevention and resolution
- To truly harmonize Pillar One with U.S. domestic law, significant changes would be required, most of which would require Congressional action
- In addition, existing U.S. bilateral treaties would generally interfere with Amount A, and amendments would be needed
- The Blueprint contemplates a multilateral agreement, which the U.S. does not enter into as a policy matter

Pillar One: Double Taxation, Source, FTC

- The Blueprint recognizes the potential for double taxation inherent in Pillar One, which is expected to be addressed through either an exemption or credit system
- An exemption system (which would be most consistent with Pillar One's notion of "reallocating" taxing rights among jurisdictions), could be a relatively straightforward alternative in a territorial regime
- In the U.S. worldwide tax system, double taxation would have to be alleviated through the foreign tax credit ("FTC")
- The availability of the FTC, in turn, depends on source
  - Under U.S. law, an FTC is generally only available to the extent of U.S. tax imposed on a taxpayer's foreign source income

Pillar One: Who Pays?

- Amount A reallocates residual profit based on a formulary approach
- The liability for the tax on amount A is then imposed on “paying entities”, determined through the following steps:
  - 1. Activities: Identify entities that make a “material and sustained contribution to the group’s ability to generate residual profit”
    - Determined by looking at transfer pricing (ALP, FAR, DEMPE and actual transfer pricing methods used)
  - 2. Profitability: Identify entities from step #1 that can support the Amount A liability (i.e., generate sufficient residual profit)
  - 3. Market Connection: Allocate liability, in order of priority, to entities identified in step #2 with a connection to the market jurisdiction
    - Determined based on activities and connection to residual profits; does not have to involve physical presence in the jurisdiction
  - 4. Back-Stop (Pro Rata): If entities with market connection cannot pay, allocate to other paying entities (until down to routine profit)
- Process indicates approach that takes into account actual supply-chain and transfer pricing, but conceivable entities in particular jurisdiction bear tax on amounts that have already been reallocated through transfer pricing
- If paying entities are also determined using formulary approach, distortions would be exacerbated

Pillar One and Sourcing Rules

- Simple Example: Assume U.S. taxpayer only has presence in the U.S., provides internet-based search services, has customers in Country Y and generates income that is characterized as U.S. source. If such taxpayer were to become liable for tax on Amount A to a foreign jurisdiction, no amount of such tax would be eligible for the U.S. foreign tax credit

Select U.S. Source Rules by Type

Type of Income	General Principle
• Services (861/862(a)(3))	• Location of activity
• Rents or royalties (861/862(a)(4))	• Location of property/use
• Sale of purchased inventory for export (861/862(a)(6))	• Location of sale
• Sale of production inventory for export/import (863(a)(5))	• Post TCJA, place of production
• Sale of personal property other than inventory and certain other exceptions (865(a))	• Residence
• Sale of personal property (other than inventory if US resident) through office or fixed place of business (865(e))	• Location of office/fixed place of business (except if inventory property sold by non-resident for use O/US and foreign office materially participates in sale)

Pillar One and Sourcing Rules

- Proposed treasury regulations address various tax aspects of transfers of digital content (Prop. Treas. Regs. 1.861-18) and of "cloud transactions" (Prop Treas. Regs. 1.861-19)
- A "cloud transaction" is a transaction through which a person obtains on-demand network access to computer hardware, digital content, or other similar resources, other than on-demand network access that is de minimis taking into account the overall arrangements and surrounding facts and circumstances. It does not include network access to download digital content for storage and use on a person's computer or other electronic device.
  - The definition of cloud transaction is intended to be expansive and cover a broad section of the digital economy, applying not only to computer hardware and software or IaaS, PaaS and SaaS models, but also other transactions that share characteristics of on-demand network access to technological resources, including access to streaming digital content and access to database information.
- The proposed regulations generally provide that a cloud transaction is classified solely as a lease of property or the provision of services. The determination is to be made taking into account all relevant factors, but in general, the "application of the relevant factors to a cloud transaction will result in the transaction being treated as the provision of services rather than a lease of property."

Pillar One and Sourcing Rules

- Under current law, income from services is sourced to the place of performance. Sections 861(a)(3) and 862(a)(3)
- Generally determined by looking to location of employees and tangible assets of the service provider
  - *Piedras Negras* – advertising income derived in connection with broadcasting activities in Mexico is foreign source even though 95% of the income was from advertisers located in the United States – broadcasting facilities and workforce were located in Mexico.
- In the case of a cloud transaction characterized as a lease, under current law source generally would be determined by reference to the location of the property/use. Sections 861(a)(4) and 862(a)(4)
- Under these rules, our U.S. taxpayer likely would not be able to credit foreign taxes imposed on Amount A, particularly in the service scenario
  - However, in cloud transactions, place of performance as well as location of property/use may not always be clear
  - *Cf.* Rev. Rul. 72-232
- Expressly reserve on sourcing of cloud transactions, requesting comments
  - Sourcing based on the location of end user? Looking to a Pillar One future?
  - Statutory constraint given services characterization?
  - Treas. Reg. 1.861-4 and applicable case law currently does not provide a basis to look to user factors

Pillar One and Sourcing Rules

- Notably, the proposed software regulations contain a new sourcing rule for sales of a copyrighted article through a digital medium, which for the place of sale generally look to the location of download or installation onto the end-user's device. If information is not available, sales are deemed to occur at the customer's location (determined based on recorded sales data)
  - Dovetails with Pillar One nexus/sourcing principles
  - Any impact from Section 863(b)?
- The preamble notes that this change is necessary because the existing rules, under which the source of income is determined by the location where rights, title and interest pass to the buyer can be easily manipulated and "bear little connection to economic reality" in the context of transactions involving digital content
- In comparison, place of sale of software on tangible media, like sales of inventory generally, occurs under the regular rules (*e.g.*, location of transfer)

Pillar One and Sourcing Rules

- Sourcing rules are detailed and complex, and numerous changes likely needed
  - Some potentially achievable through regulation
- Is there an “easier” way?
  - Treaty amendments to permit Amount A taxation could in many cases automatically facilitate the related FTC
  - Article 23 – The United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens the income tax paid or accrued to the contracting state; for this purpose, any item of gross income that under the treaty may be taxed by the contracting state is deemed to be income from sources in the contracting state
  - Separate credit basket (Treas. Reg. Section 1.904-4(k))
  - Not easier in reality, plus significant FTC changes should be in the Code
- But would just facilitating the FTC be sufficient in a Pillar One world?
  - Sourcing rules are relevant to many aspects of the U.S. international tax system

Pillar One, Sourcing and FDII

- If the U.S. were to revise its sourcing rules to be more in line with Pillar One, what does that look like? OECD guidance or some deviation?
- Existing FDII regulations could provide some inspiration
  - The FDII regime and sourcing rules are not harmonized today and there can be cases in which an item of income is FDII but is U.S. source or an item of income is foreign source but not eligible for FDII
  - Sourcing rules look to traditional principles such as location of production or service activity, whereas FDII is focused on market location (similar to Pillar One)
- FDDEI producing transactions: income derived in connection with (i) property which is sold by the taxpayer to any foreign person and which the taxpayer establishes is for a foreign use and (ii) services provided by the taxpayer which the taxpayer establishes are provided to any person not located in the United States
  - Service prong generally looks to where customer resides/where service is provided
  - Destination of "electronically supplied services" (including, e.g., streaming services) determined by reference to the location of the device used to receive the service (generally, by reference to IP address). Treas. Regs. §1.250(b)-5(c)(5)
  - For sales of digital content (not on tangible media), FDII foreign use rules would generally harmonize with the proposed Regulations under 1.861-18. Treas. Reg. 1.250(b)-4(d)(1)(ii)(D)
  - For sales of actual inventory, FDII foreign use and source rules would generally diverge

Pillar One, Nexus and FDII

- If the U.S. were to revise its sourcing rules to be more in line with Pillar One to permit the FTC, would it also change its views on nexus? Should it?
- Under the U.S. worldwide system of taxation of U.S. residents, source is really the only relevant consideration
  - Source determines availability of the FTC
  - Whether income in question is attributable to a U.S. resident's physical presence outside of the U.S. is not relevant to the question as to whether that income is taxed (or, for the most part, how)
- Foreign branch?
  - The TCJA created a separate FTC basket for foreign branch income
    - Limits cross-crediting
  - Foreign branch income is not eligible for the FDII regime
    - Rationale? Encourage activity in the U.S.? Intangibles? U.S. tax revenue?
  - Foreign branch defined by reference to foreign activities, but only if they rise to level of trade or business and there are (or are deemed to be) separate books and records.
    - Foreign branch basket does not include items "arising from activities carried out in the United States" Treas. Reg. Section 1.904-4(f)(2)(ii)
    - Activities carried out outside the United States that constitute a permanent establishment pursuant to treaty are treated as activities outside of the U.S. Treas. Reg. Section 1.904-4(f)(2)(vii)(B)

Pillar One and the Foreign Tax Credit

- In addition to harmonizing the sourcing rules, to alleviate double taxation under Pillar One, any tax on Amount A would need to be creditable under U.S. rules
- Tax on Amount A is styled as a net income tax, accordingly under existing Treasury Regulations would likely be creditable under Section 901
  - Fairly flexible standard: Treas. Regs. Section 1.901-2, a foreign levy is an income tax if it is (1) a tax, (2) likely to reach net gain in the normal circumstances in which it applies (must meet realization, gross receipts and net income requirement), and (3) it is not a “soak-up” tax
- Proposed regulations under 901 and 903 deny creditability to “novel extraterritorial taxes such as digital services taxes, diverted profits taxes, or equalization levies”

Pillar One and the Foreign Tax Credit

- Recently proposed regulations would add a "jurisdictional nexus requirement"
  - Tax must conform with established international norms (as reflected in the Code) regarding transfer pricing, taxable presence in the taxing jurisdiction, and for taxing cross-border income based on source or location of property
  - Foreign tax law must determine income based on nonresidents' activity in the country (function, assets and risks), using principles similar to Section 864(c) or U.S. Model Treaty permanent establishment rules
    - Expressly does not include countries that impose tax by using as a significant factor the location of customers, users, or any similar destination-based criterion.
  - Foreign tax law's transfer pricing rules must be determined under arm's-length principles
    - Expressly does not include allocation of profits to a resident on a formulary basis; worldwide taxation and CFC regime ok
- Would clearly deny FTC for Amount A tax (for multiple reasons)
- Treasury recognized that if Pillar One agreement reached, "changes to the foreign tax credit system may be required at that time"

Pillar One and U.S. Int’l Tax Mechanics

- Pillar One refers to “reallocating” income, but Amount A creates an additional taxing right, it does not actually move income around entities for tax purposes (local or U.S.)
- Amount A Process:
  - profit is determined at the group level based on financial statements,
  - “excess” profit is then allocated to markets based on formulaic principles that do not correspond to the arm’s-length principle,
  - the tax on such profit is then allocated down to individual “paying” group members based on factors not directly related to taxable income under existing rules, including type of function/activity, profitability and connection to the market jurisdiction
- Can result in double taxation, for example, when Amount A is allocated to a market jurisdiction that already earns a high rate of return but no entity in such jurisdiction is a paying entity, or if an entity that is allocated Amount A for a jurisdiction does not bear the full amount of the Amount A tax liability in that jurisdiction
- In most cases, there will be a mismatch with income for local tax and U.S. tax purposes

Pillar One and U.S. Int’l Tax Mechanics

- Sourcing generally would not be an issue in respect of reallocations of Amount A among CFCs, but how would the FTC for Amount A be calculated?
- FTC rules are famously complex, and it is unclear how they would interact
- Generally speaking, the FTC process (whether for the direct credit, or more relevant to U.S. MNEs, the indirect GILTI credit) involves: (1) allocation of items of gross income to baskets by reference to a corresponding U.S. item, and (2) allocation of expenses, including foreign taxes, to those items of income
- Amount A is not an item of income in the tax sense, it’s really just a number
    - What is the corresponding U.S. item (or for that matter, what is the baseline item)?
        - The regulations deal with tax base differences today, but typically there is a specific transaction or item the treatment of which can be compared
        - If at CFC, assume everything is in GILTI basket? Otherwise in general?
    - Expense allocation step also not really possible given that Amount A starts with consolidated financial statement PBT
    - Amount A tax could be traced to Amount A
        - To the extent that tax on Amount A is viewed as simply imposing a different tax on the same income may be workable, but seems unlikely in practice

Pillar One and U.S. Int’l Tax Mechanics

- High-Tax Exclusion
  - Because Amount A tax liability does not necessarily match up with taxable income in any particular entity, tax for which a CFC is liable could be “artificially” (relative to both U.S. and local tax principles) too high or too low
  - In situations where the paying entity is not a tax resident in the jurisdiction to which the Amount A tax is payable, is there a separate tested unit?
  - If there is a separate tested unit, what income is allocated to that unit?
- Transfer Pricing
  - An approach to harmonizing Amount A with local and U.S. tax rules could be to update transfer pricing rules and actually re-allocate income to a member of the group that is the paying entity for Amount A
  - But likely difficult to “translate” from financial statement to U.S. tax appropriately

MCLE Verification Code

H

U.S. Integration: Amount A Safe Harbor?

- In December 2019, the U.S. Treasury recommended that Pillar One become an optional safe harbor rule, allowing multinationals that would otherwise be within the scope of Amount A to elect to apply Pillar One, thereby getting the benefit of enhanced dispute resolution procedures in exchange for increased taxes.
  - Stated concerns over Pillar One's departure from existing permanent establishment rules and arm's-length principle
- Would essentially allow U.S. companies to elect into the Amount A regime if desirable to obtain greater taxing certainty
- Under this approach, U.S. would presumably continue to disallow a foreign tax credit for digital service taxes
- What about Amount A taxes under a safe harbor regime?
  - Treas. Regs. Section 1.901-2(a)(2)(i) requires a foreign tax to be compulsory, voluntary tax payments are not creditable
- Changes to U.S. inbound provisions would also be necessary for U.S. participation

Pillar One and U.S. Tax Treaties

- U.S. Tax Treaties with participating jurisdictions would need to be amended to permit imposition of Amount A tax
- What does Pillar One look like without uniform agreement?
- For example, assume Country Y would be allocated an Amount A reallocated from the U.S. under Pillar One
  - If U.S. is paying entity: Article 7 – business profits may be taxed only in the state of residence unless the enterprise carries on business in the other contracting state through a permanent establishment and such profits are attributable to that permanent establishment
  - If subsidiary in Country Y is paying entity: Article 9 – where a contracting state includes in the profits of a resident profits on which an enterprise of the other contracting state has been charged to tax in that other contracting state, and the other state agrees that the profits so included are profits that would have accrued to the resident of the first state under arm's-length principles, then the other contracting state must make appropriate adjustments to its tax on such profits