THE HIGH ROAD AND THE LOW ROAD: WHAT SHOULD BE THE UNITED STATES' REACTION TO THE END OF PILLAR ONE?

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ABSTRACT

The likely failure of Pillar One of the Base Erosion and Profit Shifting (BEPS) 2.0 effort raises the question of what the United States (US) may do in response. One possible response to the revival of unilateral measures such as Digital Services Taxes (DSTs) and withholding taxes is to deny them foreign tax credits and possibly engage in other retaliatory measures. However, these measures are unlikely to persuade other countries not to tax US Multinational Entities (MNEs) and, in the long run, may be more likely to harm the US economy by increasing double taxation of US MNEs and reducing trade. One other option is for the US to adopt Pillar One unilaterally along the lines of the Indian fractional apportionment proposal. A recent empirical study suggests that this will lead to a revenue gain of over $7.6 billion per year, much of which is derived from US MNEs selling into the US products manufactured in low-tax jurisdictions such as Puerto Rico based on intellectual property (IP) developed in the US. This may be a much better result and would be based on and justified by the global consensus on the principles of Pillar One.

1. INTRODUCTION

In the summer of 1993, the first author was desperately looking for a good introduction to international taxation, because he had been hired to teach it at Harvard Law School from January 1994 but had never practiced in the area. To his delight, he discovered Sol`s newly published International Business Taxation (1992) as well as his many articles. The book became the foundation for his classes, and Sol Picciotto`s writing has a tremendous influence on him ever since, especially in his consistent preference for taxing multinational enterprises (MNEs) as a unit and rejecting the arm`s length principle. He has since met Sol in person many times and every time benefited from his wisdom and insight.

This contribution focuses on one partial application of Sol`s preferred unitary taxation, namely Pillar One of the BEPS 2.0 effort, and explore the ways it might be implemented unilaterally if (as widely expected) Pillar One fails to be adopted multilaterally.

2. THE PROBLEMS OF PILLAR ONE

The likely failure of Pillar One of the Base Erosion and Profit Shifting (BEPS) 2.0 effort raises the question of what the US may do in response? One possible response to the revival of unilateral measures such as DSTs and withholding taxes is to deny them foreign tax credits and possibly engage in other retaliatory measures (Avi-Yonah and Lempert, 2023). However, these measures are unlikely to persuade other countries not to tax US MNEs and, in the long run, are more likely to harm the US economy by increasing double taxation of US MNEs and reducing trade (Avi-Yonah, Kim and Sam, 2022). Another option for the US is to adopt Pillar One unilaterally along the lines of the Indian fractional apportionment proposal(Avi-Yonah and Kir, 2019).[1] A recent empirical study suggests that this will lead to a revenue gain of over $7.6 billion per year, much of which is derived from US MNEs selling into the US products manufactured in low-tax jurisdictions such as Puerto Rico based on IP developed in the US. This may be a much better result and is justified by the global consensus on the principles of Pillar One.

The reason Pillar One is likely to fail is that it requires a Multilateral Tax Convention (MTC) to amend all the over 3,000 tax treaties to eliminate the Permanent Establishment (PE) and Arm's Length Standard (ALS) limitations on Amount A (the 25% of the excess profits of in-scope MNEs allocated to the market jurisdiction without regard to the PE and ALS limits imposed by the treaties). However, such an MTC is unlikely to be concluded because (a) it requires countries to give up on the DSTs and similar measures, which are politically popular and raise significant revenue, and (b) it requires the US Senate to ratify an MTC by 67 votes.

According to a recent study analysing the economics of Pillar One Amount A, 56% of Amount A is expected to be paid by US MNEs, which explains the reluctance of the US to ratify Pillar One (and in any case, ratification requires Republican votes, and the Grand Old Party (GOP) is

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[1] For similar earlier proposals see Avi-Yonah, Clausing and Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. 497 (2009), Avi-Yonah and Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment,* "The Hamilton Project," Brookings Institution (2007); also in 2007 TNT 114-38 (June 13, 2007) and in Jason Furman and Jason E. Bordoff (eds.), Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes (2008), 319; Avi-Yonah, *Slicing the Shadow: A Proposal for Updating U.S. International Taxation*, 56 Tax Notes 1511 (March 15, 1993).

adamantly opposed to the whole BEPS 2.0 endeavour) (Barake and Le Pouhaër, 2023). In addition, according to the same study, many countries would lose revenue from adopting Pillar One Amount A in comparison with their expected revenues from a DST, including France, India, Hungary, and even the entire European Union (EU) taken as a whole (while France's expected drop in revenue from DST to Amount A is not so significant, Hungary and India are worse off under the Amount A scenario and are expected to have negative net gains).[2] The study identifies 69 MNEs that are expected to be subject to Amount A (with 31 of them headquartered in the US and 13 in China) and finds that even if US MNEs pay 56% of Amount A, the US would be the largest beneficiary (by a considerable margin) from a revenue gain perspective.[3] Results of the study indicate that Amount A does not necessarily generate more tax revenue than DSTs for certain jurisdictions (due to the limited pool of eligible MNEs),[4] which explains why countries like Nigeria rejected Pillar One on revenue grounds (PWC Nigeria, 2022).

If Pillar One fails, and existing DSTs come back into force, many more countries are likely to adopt DSTs or withholding taxes (under United Nations Model article 12B) on the income derived from providing digital services into their market. How will the US respond? There are two likely options: A bad one (the low road) and a good one (the high road).

3. BACKGROUND**

Pillar One has two primary components—Amount A and Amount B—with detailed operative rules under 7 Titles and 10 Schedules (OECD, 2022a). Amount A is essentially a new taxing right intended to benefit jurisdictions where goods or services are supplied or where consumers are located ("market jurisdictions"). Amount A applies to MNEs whose revenue for the relevant period[5] exceeds EUR 20 billion ("revenue test") and whose pre-tax profit margin is greater than 10 percent ("profitability test"). A market jurisdiction is entitled to tax Amount A only if the nexus test is satisfied, i.e., if the revenue of an in-scope MNE in that jurisdiction for the relevant period is equal to or greater than EUR 1 million.[6] (A lower threshold of EUR 250 thousand applies to market jurisdictions whose GDP is less than EUR 40 billion.)

Eligible market jurisdictions that satisfy the nexus test are then reallocated—by virtue of a profit allocation formula[7]—25 percent of the MNE's pre-tax profit that exceeds the 10 percent profitability threshold ("residual profit"), subject to adjustments under the marketing and distribution profits safe harbour.[8] The profit allocation formula ensures that each market jurisdiction is allocated a portion of the residual profit that is in proportion to the amount of revenue generated therein, which itself is based on specific revenue sourcing rules for various categories

**Article was finalised prior to the publication of the Amount B rules

[2] Id, at 17.

[3] Id, at 12-13.

[4] Id, at 3.

[5] Generally, 12 months, but if the period is shorter or longer, the revenue threshold is adjusted accordingly. Amount A, Title 1, Article 1, Paragraph 2(a).

[6] Amount A, Title 3, Article 3.

[7] $Q = (P - R \times 10\%) \times 25\% \times L/R$. ("Q" is the amount of profit of the MNE allocated to a jurisdiction; "P" is the adjusted profit before tax of the MNE; "R" is the revenue of the MNE; "10%" is the profitability threshold; "25%" is the reallocation percentage; "L" is the revenue of the MNE that arises in that jurisdiction.) Amount A, Title 4, Article 6, Paragraph 2.

[8] Amount A, Title 4, Article 6, Paragraph 5. The safe harbour adjusts the allocation of Amount A for market jurisdictions that already have a taxing right over residual profit.

of transactions.[9] Another aspect of Amount A worth mentioning is the elimination of double taxation rules wherein "relieving jurisdictions" have an obligation to eliminate double taxation with respect to Amount A profit.[10] Implementation of Amount A is intended through execution of an MTC that rests on a) commitment to withdraw existing DSTs and relevant similar measures and commit not to enact them in the future, and b) agreement to eliminate allocation of Amount A to dissenting jurisdictions(OECD 2022b).

Amount B (the other component of Pillar One) aims to "simplify and streamline the pricing of in-country baseline marketing and distribution activities while ensuring outputs consistent with the arm's length principle for all in-scope jurisdictions" (OECD 2022c). To be clear, it is neither a new taxing right allocated to market jurisdictions nor is it limited to MNEs with annual revenue or profitability over a certain threshold. Amount B's noteworthy objective is to reduce transfer pricing (TP) disputes emanating from issues such as whether a controlled transaction involves the performance of "baseline" activities (where the distributor's functions performed, assets owned, and risks assumed are limited) or more complex activities (where the distributor's risks are economically significant).[11] Interestingly, it retains a particular focus on "low-capacity jurisdictions" to assist them in administering the arm's length principle.

Amount B is intended to apply to two categories of intra-group transactions:[12] 1) buy-sell arrangements where a distributor resident in a particular jurisdiction buys from an associated enterprise resident in another jurisdiction and then sells to unrelated parties primarily in its local market; and 2) sales agency and commissionaire arrangements where the distributor contributes to the distribution activities similar to buy-sell arrangements in the first category. Such intra-group transactions are further tested to determine whether they tick the boxes prescribed under a "scoping criteria" that includes an inexhaustive list of general features of baseline marketing and distribution activities such as: the existence of a written contract reflecting the transactional relationship, carrying out of distribution activities limited primarily to the market of residence; and not performing disqualifying activities (manufacturing, R&D, procurement, financing, etc.) or economically significant risk control functions.[13] Incidentally, Amount B is not intended to apply to intra-group transactions that are otherwise covered under an advanced pricing arrangement or those that involve the distribution of certain excluded commodities.[14]

In addition to the scoping criteria noted above, Amount B also contains a "pricing methodology" that includes a common benchmarking search criteria typically used to identify comparable entities/activities and relevant economic characteristics to correlate the distributor's activities with profitability, which is intended to be based on publicly available financial data and regularly updated to reflect the latest arm's length results.[15] The principal aim of developing such pricing methodology is to standardise the benchmarking search criteria for taxpayers and tax

[9] Amount A, Title 3, Article 4.
[10] Amount A, Title 5, Articles 7-10.
[11] Id, at 6.
[12] Id, Section 3.1.
[13] Id, Section 3.1.
[14] Id, Sections 3.1 and Section 3.4, Box 3.2.
[15] Id, Section 4.1. The final output could either be in the form of a "pricing matrix" (a matrix of arms' length pricing outcomes where comparable entities would be grouped in subsets) or a "mechanical pricing tool" (a formula or set of quantitative adjustments to determine profitability returns based on economically relevant characteristics of the distributor).

administrations and reduce disputes in relation thereto.[16] There are, of course, strict documentation requirements that build upon the existing OECD guidelines with respect to maintaining accurate and comprehensive TP documentation to assist tax administrations in pricing in-scope transactions in accordance with the Amount B pricing methodology noted above.[17] Lastly, Amount B's dispute prevention/resolution mechanisms include utilising bilateral or multilateral advanced pricing arrangements and mutual agreement procedures; in the worst-case scenario, where competent authorities cannot reach a resolution, taxpayers may initiate arbitration proceedings under the applicable treaty.[18] Note that the design of Amount B is still under consideration, and an agreement on all aspects has yet to be reached. There are concerns that the Amount B scoping criteria, based on quantitative and qualitative tests, may risk being held hostage by subjective analyses and interpretation by tax administrations (Pepper, Bettge and Coleman, 2022).

4. THE LOW ROAD: DOUBLE TAXATION AND TARIFFS

In one way, the US has already responded. It imposed tariffs on French products in retaliation for the French DST and announced its intention to impose similar tariffs on other countries. In addition, it adopted regulations intended to deny foreign tax credits not only to DSTs but also to any income tax imposed based on the location of consumption. It will also refuse to agree to the imposition of withholding taxes under revised treaties. At the extreme end, there is the option of using section 891 of the Code (which has never been invoked) to double the US tax rate on citizens and corporations of other countries that subject US citizens or corporations to "discriminatory or extraterritorial taxes".

This is a very bad outcome. The tariffs on selected imported products from France did not affect French behaviour but did affect the US prices of French goods and harmed US consumers. Double taxation of US MNEs by denying foreign tax credits not just to DSTs (which are not income taxes but can be seen as in lieu of taxes) but also to withholding taxes (accepted as in lieu taxes) and even corporate income taxes can lead to decreased US investments and harms both US consumers and US workers. Additionally, doubling the tax rates on, e.g., all EU corporations (if, as expected, the EU adopts a DST) will cause real damage to the most important US trade relationship with a crucial partner. The primary beneficiary from these steps is likely to be China.

Further, it is not as if tariffs can be imposed on all trade partners. After finding India's 2% equalisation levy on e-commerce supplies to be discriminatory following an investigation under Section 301 of the *Trade Act* (US Trade Representative, 2021), the proposed tariff retaliatory measures were suspended after an agreement was reached that the 2% equalisation levy would continue, subject to future credit to an MNE against its future Pillar One Amount A tax liability (i.e., until Pillar One is implemented or March 31, 2024 – whichever is earlier) (EY, 2021).

5. THE HIGH ROAD: UNILATERAL ADOPTION

There is an alternative US response. According to the same economic analysis, the US is the biggest beneficiary from Pillar One: It raises over $7.6 billion a year in additional revenue after accounting for the elimination of double taxation. This represents 42% of the entire global revenue gain from adopting Pillar One. The result is not surprising because the US is a very large market.

[16] Id, Section 4.1.
[17] Id, Section 5.
[18] Id, Section 6.

Moreover, US corporations account for 56% of global amount A, and as we know from many TP cases (e.g., Perrigo, Medtronic), many large US MNEs develop IP in the US and then transfer it via a cost-sharing agreement to an affiliate in a low tax jurisdiction like Puerto Rico, and subsequently sell all or most of the resulting products (e.g., drugs or medical devices) into the US market. Such "round-tripping" is a particularly good target for US taxation because most of the value was added in the US.

Admittedly, the US has so far not been inclined to go down this road, preferring the low road. However, that may not last if the rest of the world adopts DSTs or other taxes on the digital giants, none of which are currently creditable. Canada has already declared its intention to adopt a DST from 2024 despite US threats, and since the US is not likely to ratify a Pillar One treaty and US ratification is essential for such a treaty to come into force, other countries will be free to do so from 2025. Under these circumstances, there will be intense pressure by the multinationals for the US to accept the status quo and grant foreign tax credits at least for income taxes imposed on them, and possibly for DSTs as well since they can be regarded as imposed in lieu of income taxes.

However, can the US do this without a Pillar One MTC? Yes, for two reasons. *First*, the information needed to calculate Amount A and apply it unilaterally is publicly available. This is the basis for the Indian fractional apportionment proposal to apply Pillar One concepts to MNEs selling into India. The data on which the economic analysis cited above was based are all publicly available (i.e., data from Forbes and Orbis).

India's 2019 proposal on "profit attribution to permanent establishment" (CBDT, 2019) is a fractional apportionment method that targets non-residents who have a business connection in India (based on a significant economic presence threshold) and derive sales revenue from India through a business whose complete operations are not carried out there. Under the proposal, the income from that kind of business that is attributable to the operations carried out in India (and deemed to accrue or arise there) is to be apportioned using a formula that equally weighs sales, employees, and assets:

Profits attributable to operations in India = Profits derived from India x [SI/3xST + (NI/6xNT) + (WI/6xWT) + (AI/3xAT)]

Where:

SI = sales revenue derived by Indian operations from sales in India

ST = total sales revenue derived by Indian operations from sales in India and outside India

NI = number of employees employed with respect to Indian operations and located in India

NT = total number of employees employed with respect to Indian operations and located in India and outside India

WI= wages paid to employees employed with respect to Indian operations and located in India

WT = total wages paid to employees employed with respect to Indian operations and located in India and outside India

> *AI =* *assets deployed for Indian operations and located in India*
>
> *AT =* *total assets deployed for Indian operations and located in India and outside India*

The first component of the above main formula — that is, profits derived from India — is to be calculated using another formula:

> *Profits derived from India = Revenue derived from India x Global operational profit margin*

Where:

- revenue derived from India includes all receipts arising or accruing (or deemed to arise or accrue) from India; and
- the Earnings Before Income Tax Depreciation and Amortisation (EBITDA) margin is taken as the global operational profit margin.

If the global operational profit margin is negative (in case of global operational losses), the profits derived from India would be the higher of either the amount arrived at under the above formula or 2 percent of the revenue derived from India. In other words, the profits derived from India — irrespective of global operational losses — cannot be less than 2 percent of the revenue derived from India. Under the proposal, the formula to determine profits attributable to operations in India will be modified for non-residents whose business operations have a prescribed user participation in India. That is intended to tax businesses that use digital means to generate revenue, for which user participation is vital. (The proposal seeks to incorporate users as a fourth factor in profit attribution and modifies the formula accordingly based on low/medium to high user intensity). Notably, the Indian proposal does not require consolidation of profits from all jurisdictions and restricts itself largely to information related to Indian operations.[19] Facets of the Indian proposal have been baked into the Pillar One Amount A following the OECD's "unified approach" to avoid jurisdictions from adopting "uncoordinated unilateral tax measures" (OECD, 2019).

Second, the US has a long tradition of overriding tax treaties so that it is not bound by the limitations imposed by articles 7 and 9 of its treaties. Given that (a) it is widely conceded (including by the US and the OECD) that treaties should not be used to enable double non-taxation, (b) the PE and ALS limits do enable such double non-taxation when digital services are provided into the US market, and (c) the October 2021 agreement shows that almost the entire world agrees with Pillar One in principle, such overrides would be perfectly justified.

For a long time, the US differed from the rest of the world in not having a VAT, which means that everyone else got to derive revenue from taxing US exports, but the US could not derive revenue from taxing US imports.[20] Especially given the persistent US trade deficit and the unlikelihood that the US will adopt a VAT soon, the unilateral adoption of Pillar One is the best available response to the failure of the MTC.

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[19] Id, at 80.

[20] This does not imply, however, that a VAT promotes exports. *See* Joel Slemrod, *Does a VAT Promote Exports?*, in THE VAT READER 186 (2010).

This proposal could even get some bipartisan support given that the GOP has long complained about the competitive disadvantage to the US from not having a VAT. Conceptually, the idea behind Pillar One is similar to the GOP proposal for a Destination Based Cash Flow Tax, except that Pillar One taxes are less similar to a VAT because they are only imposed on the net profit from selling into the US and not on the gross amount.

Unilateral adoption by the US also makes sense, given that other jurisdictions may not really wait, either. In February of this year, the French Finance Minister claimed that progress on Pillar One is blocked because of the position of the US, India, and Saudi Arabia and that “chances of success are slim.”; he suggested that the EU should march ahead with its own DST instead (IBFD, 2023).

6. CONCLUSION

The current moment presents the US with a stark choice. Faced with the likely failure of Pillar One, it can either continue down the low road of retaliatory tariffs, double taxation and a “tax war” with its allies who are likely to respond in kind, or it can take the high road and gain significant revenue from adopting Pillar One unilaterally. It is up to Treasury and the Congress to choose. Ultimately, tax is all about politics, as so often illustrated by Sol Picciotto’s research.

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