The Foreign Tax Credit Implications of Reallocating the Income of "Digital" Taxpayers

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1. How we got here: DSTs and the OECD
2. The U.S. foreign tax credit today
3. Proposed regulations on “novel extraterritorial taxes”
4. The proposed regulations in an unsettled international tax landscape
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Planting the Digital Tax Seed at the OECD

- 2013: Addressing the Tax Challenges of the Digital Economy (er, "Digitalisation") declared Action 1 in OECD/G20 BEPS Project
  - "Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties"
  - Issues to be examined:
    - The ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules
    - The attribution of value created from the generation of marketable location relevant data through the use of digital products and services
- 2015: Action 1 Final Report
  - "Difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes"
  - Options identified but not "recommended at this stage":
    - A new nexus in the form of a significant economic presence
    - A withholding tax on certain types of digital transactions
    - An equalisation levy
  - Report by 2020 reflecting "the outcome of the continued work in relation to the digital economy"

U.S. Opens the Door to a Broader Approach

- 2018: Tax Challenges Arising from "Digitalisation" - 2018 Interim Report
  - Three groups of countries:
    - *Group 1*: Highly digitalized business models lead to misalignment between where profits are taxed and "the location in which value is created"
    - *Group 2*: Digitalization part of broader globalizing trend that "present challenges to the continued effectiveness of the existing international tax framework for business profits"
    - *Group 3*: BEPS worked, move on
  - US & China occupy Group 2, reflecting a temporary (?) shift in US position
  - "Here's what a DST looks like: don't do it"

Two Pillars and the ABCs

- January 2019: OECD Policy Note announces countries will "explore" proposals under 2 pillars "without prejudice"
  - *Pillar 1*: "Allocate more taxing rights to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not recognised in the framework for allocating profits"
  - *Pillar 2*: "Strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits"
- October 2019: Secretariat Proposal for a "Unified Approach" under Pillar 1
  - Scope: Highly digitalized business models and consumer-facing businesses
  - Nexus: New nexus not dependent on physical presence but largely based on sales
  - Profit Allocation: Three-tier profit allocation mechanism as overlay on existing arm's length results:
    - *Amount A*: New taxing right for market jurisdictions based on MNE group's deemed residual profits
    - *Amount B*: Fixed remuneration for routine distribution and marketing activities in market jurisdiction
    - *Amount C*: ?? Additional amount for market jurisdiction

In the Meantime… Unilateral Measures

- Indian Equalization Levy (2015)
  - 6% tax on gross revenue from digital advertising to Indian residents
  - 2% tax on gross revenue from online sales of goods and services to Indian residents (starting in 2020)
- UK and Australian Diverted Profits Taxes (2015 & 2017)
  - “Avoided PE” and “diverted profits” prongs
- France and UK Digital Services Taxes (2019)
  - France: 3% tax on gross revenue from online advertising and digital intermediation services
  - UK: 2% tax on gross revenue from social media, search engines, and online marketplaces
- UK Offshore Receipts Tax (2019)
- And many others….

US Backs Away at the OECD and Takes Aim at DSTs

- Mnuchin letter to OECD Chief Gurria (December 2019)
  - “Serious concerns” about mandatory departures from arm’s length transfer pricing and taxable nexus standards
  - Taxpayer concerns could be addressed by “making Pillar 1 a safe harbor regime”
- Section 301 investigation determines French DST “unreasonable or discriminatory and burdens or restricts US commerce (December 2019)
  - Tariffs up to 100% on cheese and handbags
- Section 301 investigation of enacted or proposed DSTs in Austria, Brazil, the Czech Republic, India, Indonesia, Italy, Spain, Turkey, the UK, and the EU (June 2020)
- Mnuchin letter to Finance Ministers of France, UK, Germany, Italy, and Spain declaring OECD Pillar 1 talks at an “impasse” and suggesting a “pause” in the negotiations (June 2020)
- Treasury proposes regulations under sections 901/903 denying creditability of “novel extraterritorial taxes such as digital services taxes, diverted profits taxes, or equalization levies” (September 2020)

OECD Proposes a Pillar 1 Blueprint

- On October 14, the OECD delivered "Blueprints" of Pillar 1 and Pillar 2
- Pillar 1 includes Amounts A & B, but not Amount C
- Scope: Amount A applies to Automated Digital Services (ADS) and Consumer Facing Businesses (CFB)
- Nexus: New Amount A taxing right solely based on country-specific revenue for ADS, while Amount A nexus for CFB based on country-specific revenue coupled with "plus" factors
- Amount A: Eligible market jurisdictions receive a formulaically determined portion of the MNE group's residual profit above a specific threshold
    - Residual profit margin determined as group profit margin (as percent of revenue) less an agreed threshold (X%)
    - Allocation to market jurisdiction: Local in-scope revenue * Y% * (Group profit margin – X%)
        - For example, 20% of the excess of the group profit margin over 10% ("20 over 10")
    - Group (or regional or business line) profit margin determined based on adjusted profit before tax (PBT) measure derived from MNE group's consolidated financial statements

Amount A Details

- Ceding Jurisdiction: To avoid double taxation, the jurisdictions of "paying entities" within the MNE groups would cede primary taxing jurisdiction to the market jurisdictions allocated Amount A taxing rights
  - Paying entities, identified based on a series of tests, generally correspond to entities within the MNE group that make "material and sustained contribution" to group's ability to generate residual profits (under the ALP)
  - Ceding of taxing jurisdiction could be accomplished under exemption or credit method
- Safe Harbor: Under a "marketing and distribution profits safe harbor," no Amount A allocation if market jurisdiction return under existing ALP exceeds safe harbor return
- Implementation: Amount A would be implemented through domestic law and a new multilateral convention upon adoption by a "critical mass" of countries
  - Domestic law changes needed to implement new taxing right and cede taxing jurisdiction, as necessary
  - Multilateral convention would overcome obstacles to Amount A taxation in existing bilateral treaties, including the permanent establishment threshold and associated profit attribution rules

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Section 901: An Early Broad View of an Income Tax

- Enacted in 1918 (in a predecessor Code section), section 901 allows citizens and domestic corporations to claim a credit for “any income, war profits, and excess profits taxes” paid or accrued during the taxable year to any foreign country or U.S. possession
- Early case law took a broad view of the section 901 reference to an “income tax”
  - Deemed profits taxes
    - In *Keen v. Commissioner*, 15 B.T.A. 1243 (1929), the court allowed a section 901 credit for a French minimum tax determined as a multiple of the rental value of French residence
  - Income tax with broad source rule
    - In *Burke Brothers v. Commissioner*, 20 B.T.A. 657 (1930), the court allowed a foreign tax credit for an Indian tax on the worldwide profits of a taxpayer that purchased goat skins through a Calcutta office and imported them to the US for processing into leather and sale
      - Indian source rule, in contrast to US source rules, treated the downstream profits as Indian source by reason of the purchase of materials in India
      - Income apparently deemed to arise upon export of skins, prior to actual sale of leather in the US
  - Gross income taxes
    - In *Seatrains v. Commissioner*, 46 B.T.A 1076 (1942), a Cuban 3% tax on gross income from foreign shipping companies (originally conceived as a 6% net profits tax) was held to be an income tax
    - Similarly, *in Santa Eulalia Mining Co v. Commissioner*, 2 TC 24 (1943), a Mexican gross tax on mining royalties paid to a mine owner was considered an income tax.

Biddle and an Income Tax "in the U.S. Sense"

- In 1938, the Supreme Court noted in passing in *Biddle v. Commissioner*, a technical taxpayer case involving a UK distribution tax, that the reference to an "income tax" in section 901 means an income tax "in the U.S. sense"
- Subsequent case law generally followed the Supreme Court's *Biddle* dicta
  - In *Keasbey & Mattison v. Rosthensies*, 133 F. 2d 894 (3d Cir. 1943), the court held a Quebec mining tax imposed on profits defined as the gross value of mine output sold, utilized or shipped was not an income tax
    - A foreign tax is not an income tax "unless it conforms in its substantive elements to the criteria established under our revenue laws"
  - Similarly in *American Metal v. Commissioner*, 221 F.2d 134 (2d Cir. 1955), the court held a Mexican mining production tax imposed on a gross basis on the deemed value of extracted ore is not an income tax
    - "The determinative question is 'whether the foreign tax is the substantial equivalent of an 'income tax' as that term is understood in the United States.'"
- But foreign tax law need not mirror US tax law exactly
  - In *Schering Corp. v. Commissioner*, 69 T.C. 579 (1978), the Tax Court allowed a section 901 credit for Swiss withholding tax imposed on foreign law dividend regarded as principal repayment for U.S. purposes, noting "exact congruence between the foreign tax statute and American tax law is not necessary to establish that a tax is an 'income tax.'"
  - Even in denying a credit for various taxes on gross income from a banking business, the court in *Bank of America v. U.S.*, 61 T.C. 752 (1974) allowed that a tax on gross income is an income tax "if it is very highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it applies."

Narrowing “an Income Tax in the U.S. Sense”

- Until the early 1970s, the Service often took a broad view of what constituted an income tax in the U.S. sense, including blessing as an income tax a Jamaican tax on assumed mining profits based on the selling price of processed ore. *See, e.g.,* GCM 34,567 (1971)
- As part of an attack in the 1970s on claims of foreign tax credits for purportedly disguised mineral royalties, however, the Service began (unnecessarily) taking a narrower view of what an income tax
  - Considering an Indonesian tax calculated based on the value of oil produced, the Service determined that the tax was a royalty but, in the alternative, argued that the tax base was “fictitious income” and that the tax does not fall “predominantly on net gain in the American sense”. GCM 36,540 (1976)
  - Additionally, in considering whether an Ontario mining tax imposed on the market value of the output at the mine head constituted an income tax, the Service determined *Keen* (French deemed income tax) was inconsistent with later-decided *Biddle* (technical taxpayer case). GCM 36,552 (1976).
- In Rev. Rul. 78-62, the Service withdrew its acquiescence in *Keen* and also determined it would not follow *Burke Brothers* (Indian tax on goat skin exports).
  - Rather, an income tax would have to be realization and net gain requirements and be imposed on “the receipt of income by the taxpayer rather than on transactions such as sales or the exercise of a privilege or a franchise, such as exploiting natural resources.”
- *Temporary and proposed section 901 regulations issued in 1980 allowed a section 901 credit only if the tax “follows reasonable rules regarding source of income, residence, or other bases for taxing jurisdiction”*

Final Regulations under Section 901

- Regulations under section 901 proposed in 1979-80 and finalized in 1983 at Treas. Reg. § 1.901-2 generally followed case law and the framework laid out in Rev. Rul. 78-62
- A foreign levy is an *income tax* only if
  - It is a *tax*
  - The predominant character of the tax is an income tax in the U.S. sense
- A foreign levy is a tax only if it requires "a compulsory payment pursuant to the authority of a foreign country to levy taxes" (e.g., not a customs duty)
  - Not a tax to the extent person subject to levy receives a "specific economic benefit" in exchange for levy payment
    - Specific economic benefit includes a right to use or extract resources but does not include "the right or privilege merely to engage in business generally of to engage in a particular form"
  - A payment is not compulsory to the extent it exceeds the amount of liability under foreign law for *tax*.
    - Taxpayer must exhaust all effective and practical remedies to reduce, over time, liability for foreign tax but may rely on advice from foreign counsel regarding reasonable interpretations
    - Where foreign tax law includes options or elections whereby a taxpayer's liability for foreign tax may be shifted, taxpayer's use or failure to use such options does not result in payment in excess of the taxpayer's foreign tax liability
- Proposed "reasonable basis for taxing jurisdiction" requirement eliminated without comment

Section 901 Regulations: An Income Tax in the U.S. Sense

- The predominant character of a tax is an income tax in the U.S. sense if the foreign tax is:
  - Likely to reach net gain in the ordinary circumstances in which it applies, and
  - Not a soak-up tax (i.e., dependent on the availability of a foreign tax credit from a country other than the country imposing the tax)
- A foreign tax is likely to reach net gain in the ordinary circumstances in which it applies if and only if, judged on the basis of its predominant character, the tax meets the following three requirements:
  - Realization: Imposed on or subsequent to a realization event in the U.S. sense or on certain pre-realization events (i.e., transfer of readily marketable property; mark-to-market regimes; or recapture of previously allowed deductions)
  - Gross receipts: Imposed on gross receipts or gross receipts computed under a method that is *likely* to produce an amount that is not greater than fair market value
  - Net income: Reduces gross receipts by
    - Recovery of significant costs and expenses attributable to the gross receipts,
    - Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses, or
    - Allowances that effectively compensate for nonrecovery of such significant costs

Section 901 Regulations: Separate Levies

- The creditability of a tax under section 901 or 903 is determined independently for each "separate levy"
- Whether a single levy or separate levies is imposed depends on U.S. principles and not foreign law
- Levies imposed by different taxing authorities are always separate levies
- Where the base of a levy is different in kind, and not just in degree, for different classes of persons subject to the levy, the levy is a separate levy with respect to each class of persons
  - For example, foreign equivalents of sections 1, 11, 541, 881, 882, 1491, and 3111 would be considered separate levies
- More separate levies ==> greater risk amounts paid under foreign tax laws are not creditable

Section 903: “In Lieu of” Taxes

- Enacted in 1942 (in a predecessor Code section), section 903 provides that the term “income, war profits, and excess profits taxes” includes a ”tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed” by a foreign country or U.S. possession
  - Enacted partly in response to post-*Biddle* cases denying section 901 credits for gross income taxes imposed on certain industries like mining, banking, and shipping
- Under Treas. Reg. § 1.901-3, a foreign levy is a tax in lieu of an income tax if and only if:
  - It is a tax (within the meaning of Treas. Reg. § 1.901-2(a)(2))
  - The tax “in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or series of income taxes otherwise generally imposed” (the “substitution requirement”)
- Creditability under section 903 independent of:
  - Foreign country’s purpose in imposing the tax
  - Whether base of the foreign tax bears any relation to realized net income (may be gross receipts, sales, or number of units produced or exported)

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Narrowing “an Income Tax in the U.S. Sense” . . . Round 2

- On September 29, 2020, Treasury and IRS released new proposed regulations that would deny a credit for “novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction as reflected” in the Code.
- Treasury and the IRS “have determined that it is necessary and appropriate to require that a foreign tax conform to traditional norms of taxing jurisdiction as reflected in the Internal Revenue Code in order to qualify as an income tax in the U.S. sense, or as a tax in lieu of an income tax.”
  - This requirement “will ensure that the foreign tax credit operates in accordance with its purpose to mitigate double taxation of income that is attributable to a taxpayer’s activities or investment in a foreign country.”
- In order to qualify as a creditable income tax, the foreign tax law “must require a sufficient nexus between the foreign country and the taxpayer’s activities or investment of capital or other assets that give rise to the income being taxed.”
  - For example, taxes imposed where taxpayer lacks operations, employees, factors of production, or management in that foreign country “not an income tax in the U.S. sense”
- Under the proposed regulations, a foreign tax would be considered a creditable “net income tax” only if it meets the:
  - Net gain requirement
  - Jurisdictional nexus requirement

Net gain requirement

- Similar to existing final regulations, but rather than making determinations based on "predominant character", more specific rules would apply
- Realization requirement: Satisfied notwithstanding tax imposed on "one or more specific and defined classes of nonrealization events" where, judged on application of tax to all taxpayers, gross receipts subject to tax on nonrealization events relatively insignificant
- Gross receipts requirement: No longer satisfied by computing gross receipts under a method "likely" to produce an amount not greater than gross receipts
  - Must use actual gross receipts on realization or pre-realization timing difference events
  - No computation of gross receipts, e.g., based on applying a markup to costs
- Cost recovery requirement: Deductions allowed under foreign tax law must approximate cost recovery provisions of the Code
  - Unlike under current reg, no creditability of tax even in taxpayer "almost certain" have net gain after application of tax (e.g., even if there are few or not costs attributable to certain gross receipts)
  - Additionally, no longer sufficient that an allowance "effectively compensate" for nonrecovery of significant costs; foreign law must expressly guarantee allowance will equal or exceed actual costs
  - Deduction disallowance similar to under the Code (e.g. section 163(j))

Jurisdictional Nexus Requirement

- Tax on *nonresidents* must meet one of the following nexus requirements:
  - Activities nexus: Income that is taxable is limited to income that is attributable, under reasonable principles, to the nonresident's activities within the foreign country (including its functions, assets, and risks located in the foreign country), *without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion*
    - Attribution under reasonable principles includes rules similar to those for determining ECI under section 864(c)
  - Source of income nexus: Income that is taxable on the basis of source (rather than activities) is based on income arising from sources within the country that imposes the tax, but only if the sourcing rules are reasonably similar to the sourcing rules that apply for Federal income tax purposes.
    - In particular, services must be sourced based on where the services are performed and not based on the location of the service recipient
      - But where are services performed? Compare *Miller v. Commissioner* to *Le Beau Tours v. Commissioner*
  - Situs of property nexus: Income from sales or dispositions of property that is taxable based on the situs of real or movable property includes only gains that are attributable to the disposition of real property situated in the foreign country or movable property forming part of a taxable presence in the country
    - Includes interests in a company to the extent attributable to real property or business property in the country
- Tax on *residents* may be imposed on worldwide income of the resident but must provide that any allocation of income and deduction among related parties to the resident is determined on "arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.

Jurisdictional Nexus Requirement: ESS Example

- Country X Tax imposed on nonresident companies that furnish electronically provided services (ESS) to users
- <u>Alternative 1</u>: Tax based on an apportionment of the nonresident company's net income to Country X based on fraction of Country X users as compared to all users.
  - *No activities nexus*: Not computed based on activities; rather computed based on user location
  - *No source of income nexus*: Not imposed based on source
  - *No situs of property nexus*: Not imposed on sale or disposition of property
- <u>Alternative 2</u>: Tax based on sourcing of company's gross income from Country X users to Country X and reasonable apportionment of expenses.
  - *No activities nexus*: Not computed based on activities in Country X
  - *No source of income nexus*: Not imposed based on where services are performed
  - *No situs of property nexus*: Not imposed on sale or disposition of property
- Neither alternative satisfies jurisdictional nexus requirement

Separate Levies and Noncompulsory Payments

- Separate levy determination
  - Separate levies are imposed on particular classes of taxpayers if the taxable base is different for those taxpayers
  - A foreign levy imposed on nonresidents is treated as a separate levy from that imposed on residents even if the base is the same for both levies
    - Thus, if a generally imposed tax on residents is also imposed on an extraterritorial basis on nonresidents, only the portion of the levy applying to nonresidents is not creditable
  - A withholding tax on gross income of nonresidents is treated as a separate levy with respect to each class of gross income (in section 61) to which it applies
    - Thus, separate analysis required where some withholding taxes meet the jurisdictional nexus requirement and others do not
- Noncompulsory payments
  - Proposed regulations clarify that where foreign law allows elections, taxpayers are obligated to elect in a way that minimizes liability for otherwise creditable foreign tax
  - Thus, a taxpayer that elects to pay a smaller amount of income tax instead of a greater amount of excise tax would not be permitted to credit the income tax

Section 903 “In Lieu Of” Taxes

- Jurisdictional nexus requirement applied to “in lieu of” taxes as well as income taxes
- Generally-imposed net income tax would have been imposed “but for” the imposition of the “in lieu of” tax on the income excluded from the generally-imposed net income tax (the “excluded income”)
- If the generally-imposed net income tax were applied to the excluded income, it would continue to qualify as a foreign net income tax (i.e., meet the jurisdictional nexus requirement)
  - Compare Puerto Rico Act 154, creating a new extraterritorial income tax that taxpayers may elect out of into an excise tax
- “Covered withholding tax” explicitly qualifies under section 903 (not section 901)
  - Cannot be in addition to a net income tax imposed on any portion of the income subject to the withholding tax
  - Must meet the source-based jurisdictional nexus requirement
- <u>Example</u>: Gross-basis ESS tax on nonresidents who may also be subject to tax from PE in Country X does not meet substitution requirement

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Indian Equalization Levy

- Introduced in 2016 as 6% levy on gross amount paid to a non-resident for online advertising services
  - Only applies if the advertising services (“specified services”) not effectively connected to a PE of the payee
  - Indian residents doing business with the non-residents have withholding obligation
  - Classified as a transaction-based tax rather than a tax on income
- Expanded from April 2020 to include e-commerce transactions
  - Applies 2% levy on gross amount paid to a non-resident for online sale of goods or services to an Indian resident
  - Only applies if sales activities are not effectively connected to a PE of the payee
- FTC considerations:
  - Implicates proposed jurisdictional nexus requirement (not based on local activities or US source rules)

UK Diverted Profits Tax

- "Diverted profits" equal to difference between actual reported UK profits and hypothetical UK profits in alternative arrangement (e.g. UK PE or IP located in UK) taxed at 25% rather than 19%
- *Prong 1*: Avoided PE charge
  - UK company carries on activities (e.g. marketing/customer support) in connection with supply of goods or services by a related nonresident where it is "reasonable to assume" the activities of the parties are arranged to avoid a UK PE
  - Arrangements satisfied a tax mismatch condition or a tax avoidance condition
    - *Mismatch condition*: Foreign company has in place arrangement with related party (e.g., royalty payment to IP Co) where (i) tax reduced by 20%, (ii) tax reduction is more than non-tax benefit, and (iii) reasonable to assume arrangement reduce UK Tax
- *Prong 2*: Diverted profits charge
  - UK company enters into a transaction with related party (e.g. royalty arrangement) (i) tax reduced by 20% under arrangement, (ii) tax reduction is more than non-tax benefit, and (iii) reasonable to assume arrangement reduce UK Tax
- FTC considerations:
  - First prong implicates "activities nexus" of proposed jurisdictional nexus requirement for nonresidents
  - Second prong implicates arm's length requirement of proposed jurisdictional nexus requirement for residents
  - Increasing income subject to tax under regular CIT may raise voluntary payment issues

UK Offshore Receipts on Intangible Property (ORIP) Tax

- 20% UK tax imposed on gross amounts of income received by certain non-UK residents from intangible property (IP), when those amounts relate to the sale of goods or services in the UK
- Example:
  - Irish regional distributor sells branded shoes to local UK distributor and pays brand royalty to IP Co in non-treaty jurisdiction
  - IP Co subject to UK tax on royalty income connected to UK, notwithstanding lack of any direct connection to UK other than licensing non-UK resident rights to exploit IP in UK
- Sale of advertising is a UK sale where aimed at UK residents
- Anti-avoidance rule gives HMRC ability to challenge restructurings to avoid application of ORIP
- Exemptions apply where tax paid by foreign resident is at least half what UK tax would have been
- FTC implications:
  - Implicates jurisdictional nexus requirement (not based on activities in UK or US source rules)
  - Implicates cost recovery requirement

UK DST

- UK DST imposed at 2% rate on revenue from providing social media platforms, search engines, or online marketplaces to UK residents
  - Revenue thresholds: Worldwide revenue from taxable services of at least £500 million annually and total taxable revenue from taxable services from UK users exceeding £25 million annually
  - Applies to revenue arising by reason of UK user using service or being shown advertisement
  - First £25m of UK digital services revenues are exempt from the tax
  - Low margin or loss-making businesses may elect alternative calculation: DST rate applied to the operating margin on each digital service activity; if zero or negative, no DST liability for that activity
- FTC implications:
  - Implicates proposed jurisdictional nexus requirement (not based on local activities or US source rules)
  - Proposed cost recovery requirement forecloses argument that exemption of first £25m of revenue effectively compensates for non-recovery of significant costs
  - For low-margin businesses electing safe harbor, even if cost recovery requirement were satisfied, election to pay creditable net income tax instead of non-creditable

Pillar 1 with a “Critical Mass” (or Less…)

- OECD has repeatedly referred to possibility of implementing Pillar 1 based on a “critical mass” of cooperating jurisdictions
    - Potential for implementation of Pillar 1 without U.S. participation
- In the first instance, Amount A can be levied as an obligation under a country’s domestic law
- “Amount A coordinating entity” within an MNE group would file self-assessment return with a “surrogate lead tax administration” when group’s headquarters jurisdiction has not enacted provisions to tax Amount A
- Self-assessment return would be filed with an agreement signed by all MNE group entities that potentially have residual profits agreeing to be bound by self-assessment return
    - Includes entities in jurisdictions that have not themselves implemented Pillar 1?
- Payment of Amount A tax in market jurisdictions by each “paying entity” in an MNE group, or designation of a single entity within a group to pay Amount A on behalf of all group members

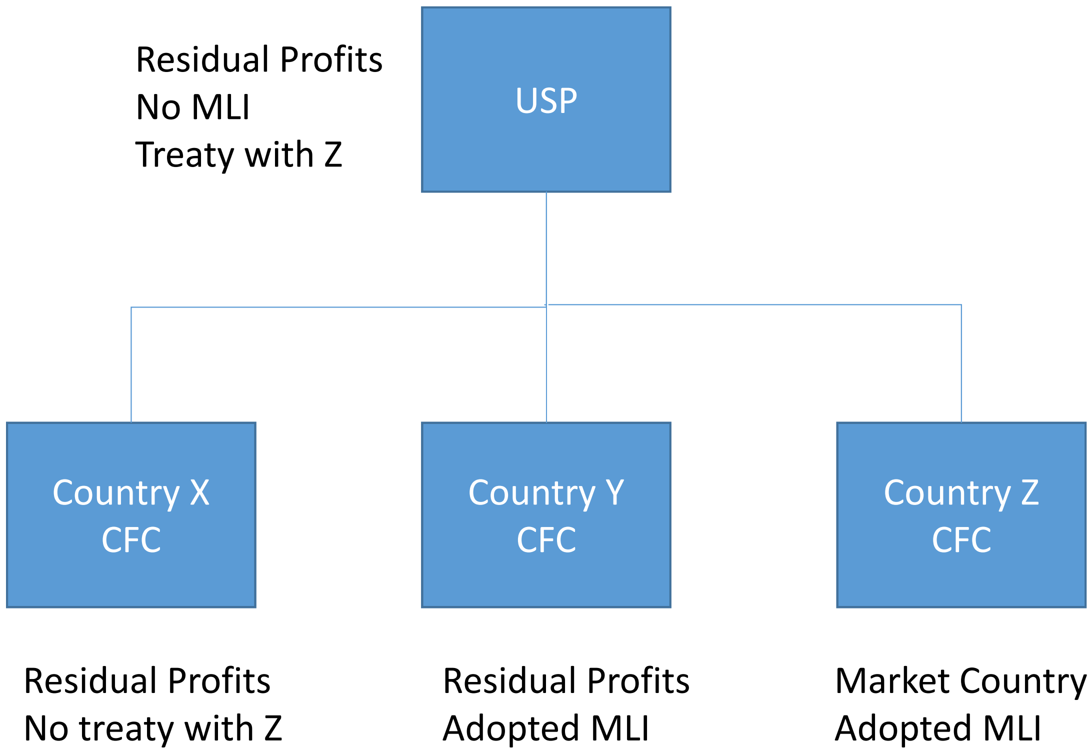
Pillar 1 with a “Critical Mass”: Relief of Double Tax?

- Nothing prevents a country from enacting legislation to tax Amount A determined on a group-wide basis, taking into account income arising in countries that have implemented Pillar 1 and those that haven’t
- But how would paying entities be determined in that case?
  - Include paying entities in non-participating jurisdictions (and accept double tax)?
  - Exclude entities in non-participating jurisdictions from being paying entities, leaving other paying entities to pay more? (unlikely “investment hubs” would agree to this as part of a consensus)
- Alternatively, on a multilateral basis, reduce Amount A by any amount that would be allocated to a paying entity in a non-participating jurisdiction.
  - Most principled approach, but implications for already modest revenue expected from Amount A
  - Under this approach, assuming US is a non-participating jurisdiction, US-based companies could avoid Amount A by locating residual profits in US.
    - Worth it?

Pillar 1 with a Critical Mass: Treaty Considerations

- To the extent Amount A reallocation is considered a tax on a nonresident, an existing bilateral treaty could prevent reallocation on the basis that:
  - The nonresident has no permanent establishment in the country imposing tax on Amount A (Article 5), or
  - Amount A is not properly attributable to the nonresident's permanent establishment in the country (Article 7)
- To the extent Amount A reallocation is considered a tax on a resident, Article 9(2) of an existing bilateral income tax treaty could require the country taxing Amount A to cede taxing jurisdiction to the country from which Amount A is reallocated:
  - "Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits."
  - But how clear is it where Amount A reallocated to a market jurisdiction is being taxed under the ALP?
- To the extent Country X and Country Y join a new multilateral instrument implementing Amount A, however, Country X could impose Amount A liability on a paying entity in Country Y
- Additionally, in practice, Country X can require an MNE group to file an Amount A return in Country X with respect to the entire group if not filed in another jurisdiction

Pillar 1 with a Critical Mass: Example



- Country Z imposes tax on USP's Amount A reallocated from US, Country X, and Country Y
- MLI allows Country Z to tax Amount A deemed allocated from Country Y, with Country Y ceding taxing jurisdiction
- No treaty barrier to Country Z taxing any portion of Amount A attributable to Country X
- US-Country Z treaty may prevent Country Z from taxing profits attributable to USP
  - No amount A reallocation to extent USP would be paying entity?
  - But who's to say any of Country Z's Amount A relates to USP's profits under ALP?

Pillar 1 : FTC considerations

- Under existing final regulations, tax on reallocated Amount A likely creditable under section 901
- Under new proposed regulations, tax on reallocated Amount A wouldn't satisfy jurisdictional nexus requirement → no US FTC
- Additionally, to the extent a taxpayer opts into Amount A tax (e.g., to avoid a DST under a "safe harbor"), "voluntary payment" issues arise → no US FTC
- Voluntary payment issues also implicated if taxpayer pays more than necessary in existing corporate income tax, purportedly under arm's length principle, to qualify for "marketing and distribution profits safe harbor" and avoid Amount A tax → no US FTC
- But where Amount A represents taxing rights shifted from "paying entity" country to "market country", *what would be the policy motivation for denying US FTC?*
  - No foreign double taxation
  - Amount A tax reaches net gain
  - Countries taxing amount A on coordinated basis rather than imposing DSTs on uncoordinated basis

1. How we got here: DSTs and the OECD
2. The U.S. foreign tax credit today
3. Proposed regulations on “novel extraterritorial taxes”
4. The proposed regulations in an unsettled international tax landscape
5. Foreign tax credit policy and potential directions

FTC Policy in the Beginning

- From 1913 to 1918, foreign taxes were deductible but not creditable
  - Lack of FTC could be viewed as “national neutrality”
    - Encourage U.S. investment whenever pre-tax rate of return on U.S. investment exceeds rate of return on foreign investment after foreign taxes
    - Foreign taxes viewed as cost of investing and operating abroad
    - U.S. revenue is better than foreign revenue
    - Consistent with a robust tariff policy
  - In contrast, FTC reflects policy of “worldwide efficiency” or “capital export neutrality”
    - Pre-tax rates of return should determine investment location
    - Indifferent to whether tax revenue flows to U.S. fisc or foreign government
- Little legislative history contemporaneous with 1918 adoption of U.S. foreign tax credit, but legislative history from 1921 noted that worldwide taxation: “results in double taxation, places American business concerns at a serious disadvantage in the competitive struggle for foreign trade, and encourages American corporations doing business in foreign countries to surrender their American charters and incorporate under the laws of foreign countries." (H. R. Rep. No. 350, 67th Cong., 1st sess., p. 8)
  - With high wartime tax rates, fairness claims resonated

Double Taxation

- Elisabeth Owens (1961): "The chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax"
  - No barrier to international trade if incidence of tax can be shifted
  - No inequity if taxpayer does not effectively bear the burden of two separate taxes
- Incidence analysis
  - Depends on whether markets are perfectly competitive or sellers have monopolistic pricing power
  - OECD Action 1 report concluded incidence of a DST or a corporate income tax on PEs of sales of digital goods and services would be the same and would fall on:
    - Consumers and labor in the case of perfectly competitive markets
    - Capital owners in the case of imperfectly competitive markets
  - Not practical for case-by-case determinations, but can rule out double taxation in certain cases (e.g. consumption taxes, tariffs)
- In what sense do two income taxes (e.g., US CIT and Pillar 1 / Amount A tax), regardless of "extraterritoriality", not result in double taxation?
- DST
  - Passed on to consumers?
  - Impact on trade if broadly applicable to all market participants?

International Comity?

- Glenn Coven (1999) suggests “international comity” as justification for a broad foreign tax credit
  - Relevance of impact on foreign governments: “Unnecessary oppression” to define creditable taxes in such a way as to influence foreign tax policy?
    - Impact on developing countries/territories (e.g, Puerto Rico excise tax)
  - Narrowly defined foreign tax credit discourages “innovation and experimentation” in tax policy?
- But MAGA…
  - New nationalisms in tax policy
  - Can U.S. FTC policy (plus tariffs) still steer foreign tax policy?
  - National neutrality back again?
    - Looking out for the US fisc
  - They’re ours to tax, not yours

Models for the Foreign Tax Credit: Jurisdictional Nexus

- US-like taxes only (proposed regs): U.S.-like source rules
  - Treasury in proposed section 901 regulations: purpose of mitigating double taxation "served most appropriately if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax"
    - Conformity extents not just to net gain requirement but also to "whether there is sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax"
  - How feasible in practice?
- Reasonable connection: Any reasonable connection between foreign country and income or activity subject to tax
  - Gesture of disapproval at foreign tax policy adventurism but not likely a meaningful constraint
  - Destination-based income taxes explicitly allowed
- Anything goes (current practice): No jurisdictional nexus requirement, provided tax reaches net income
  - FTC limitation polices consequences to US fisc
  - Other constraints (e.g., impact on consumers and economy) more effective for constraining foreign tax policy than US FTC policy

Models for the Foreign Tax Credit: Tax Base Calculation

- Range of options:
  - Strict calculation of net gain (proposed regs)
  - "Predominant character" (existing regs)
  - Liberal use of deeming devices where goal is to reach net income (early FTC cases)
- What guiding policy principle?
  - Economic incidence?
  - Competitiveness of U.S. groups operating abroad (capital export neutrality)?
  - Protection of US fisc (against what?)
    - Section 904, as well as "soak-up" tax rules, sections 901(m), 909,etc. offer guardrails
- If goal is mitigating double taxation and promoting U.S. competitiveness, what benefit does a strict approach provide?