BACKGROUND AND ANALYSIS OF THE TAXATION OF INCOME EARNED BY MULTINATIONAL ENTERPRISES

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INTRODUCTION AND SUMMARY

The House Ways and Means Committee has scheduled a public hearing on July 19, 2023, titled "Biden's Global Tax Surrender Harms American Workers and Our Economy." This document,[1] prepared by the staff of the Joint Committee on Taxation, describes the legal and economic background on the U.S. taxation of cross-border activities.

Part I includes an introduction to the basic principles of international taxation and present law. Subpart A is a general overview, subpart B describes the U.S. taxation of foreign activities of U.S. taxpayers, and subpart C describes the U.S. taxation of U.S. activities of foreign taxpayers.

Part II describes international efforts (lead in part by the Organisation of Economic Co-operation and Development ("OECD")[2] at the direction of the G-20[3]) to agree on a new means of allocating certain income of multinational corporations and to coordinate the implementation of a global minimum tax.

Part III provides an analysis of recent economic literature that addresses cross-border taxation.

Part IV provides an analysis of data based on U.S. corporate tax filings for taxable years 2018 and 2020.

Part V provides an analysis of the potential economic and revenue effects of enactment of proposals to implement a global minimum tax as outlined by the OECD.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Background and Analysis of the Taxation of Income Earned by Multinational Enterprises*, (JCX-35-23), July 17, 2023. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. Unless otherwise stated, section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] The OECD is a multinational organization dedicated to global development. The OECD was first established in 1961 by the United States, Canada, and 18 European countries and has since expanded to 38 members.

[3] The G-20 is an intergovernmental forum comprising 19 countries that represent around 85 percent of the global GDP, over 75 percent of the global trade, and about two-thirds of the world population. See https://www.g20.org/content/dam/gtwenty/about_g20/overview/G20_Background_Brief_06-03-2023.pdf.

I. OVERVIEW OF U.S. TAXATION OF CROSS-BORDER ACTIVITY

The following discussion provides an overview of international legal principles and their implementation in the U.S. taxation of income from cross-border business activity, including a description of the basic concepts of determining where income may be taxed and how these concepts are reflected in the Code.

A. General Overview of International Principles of Taxation

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct and persons (whether natural or juridical) with a sufficient nexus to the sovereign nation. The nexus may be based on nationality (*i.e.*, a nexus based on a connection between the relevant person and the sovereign nation) or may be territorial (*i.e.*, a nexus based on a connection between the relevant conduct and the sovereign nation). The elements of nexus and the nomenclature of the principles may differ based on whether the tax is a direct tax (*e.g.*, a tax on income) or an indirect tax (*e.g.*, taxes on property or sales taxes, certain value-added taxes).[4] These concepts have been refined and adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to tax. Nonetheless, most legal systems respect limits on the extent to which their laws may be given extraterritorial effect. The broad acceptance of such norms extends to authority to regulate cross-border trade and economic dealings, including taxation.

1. Principles relating to allocation of taxing rights

When determining how to allocate the right to tax a particular item of income, jurisdictions consider principles based on the origin (either source of the income or the residence of the person earning the income), or the destination of the goods or services producing income.

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

Income taxes based on a person's citizenship, nationality, or residence are residence-based taxes. The United States generally imposes residence-based taxation on U.S. persons in the year in which income is earned. For individuals and domestic entities, this results in taxing them on their worldwide income, whether derived in the United States or abroad, with limited opportunity for deferral of taxation of income earned by foreign corporations owned by U.S.

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[4] A direct tax is imposed directly on a person (known as a capitation tax), property, or income from property, the burden of which the taxpayer bears and generally cannot shift to another. In the United States, Federal direct taxes must be apportioned among the states (U.S. CONST. Art. 1, Sec. 2, cl. 3), unless they are taxes on income within the meaning of the 16th Amendment. In contrast, indirect taxes are taxes on consumption or the production of goods or services, such as the excise taxes in Chapter 32 of the Code, sales or use taxes, or customs duties, the responsibility for which can be shifted from one taxpayer to another.

shareholders. As explained below, income earned by a resident of the United States from foreign activities conducted through a foreign entity generally is subject to U.S. tax in the year earned or not at all. The United States generally taxes foreign persons on only U.S.-source income.

Destination-based principles have not been widely adopted for income tax purposes; until recently, they were generally prevalent only for indirect taxes.[5] The United States does not have a general Federal sales or use tax, although such taxes are in force in most of the States, including both origin-based taxes and destination-based taxes. Destination as a basis for determining the appropriate jurisdiction to exercise taxing jurisdiction over certain income has been proposed from time to time,[6] most recently by the OECD in the context of the international project to address new taxing rights for market jurisdictions, discussed below in Part II.

2. Resolving overlapping or conflicting jurisdiction to tax

Multinational enterprises operating in multiple countries may find that the same item of income is subject to tax under the rules of two or more jurisdictions. Such double taxation may be mitigated by domestic laws permitting credit or deduction for income taxes paid to another jurisdiction, as mentioned above, or by bilateral tax treaties. These tax treaties generally provide the primary taxing authority to the source country where the income is earned and residual taxing authority to the country of residence.

The United States is a partner in numerous bilateral treaties that aim to avoid international double taxation and to prevent tax avoidance and evasion. Another related objective of these treaties is the removal of barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. Bilateral agreements are also used to permit limited mutual administrative assistance between jurisdictions.[7]

In addition to entering into bilateral treaties, the United States participates in multilateral organizations to develop common principles to alleviate double taxation, including as a founding member of the OECD. The OECD has led such efforts since the latter half of the 20th century,

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[5] OECD, *International VAT/GST Guidelines,* OECD Publishing, 2017.

[6] A destination-based, border adjustment tax has been proposed several times in the last 20 years, including in 2005, 2010, 2016, and 2020. See President's Advisory Panel on Tax Reform, *Simple, Fair and Pro-Growth: Proposals to fix America's Tax System,* November 2005; Alan Auerbach "A Modern Corporate Tax," Center for American Progress, 2010; House Republic Tax Reform Task Force, "A Better Way: Our Vision for a Confident America," June 24, 2016; and Alan Auerbach, Michael P. Devereux, Michael Keen, Paul Oosterhuis, Wolfgang Schohn, and John Vella, "Destination-Based Cash Flow Taxation," *Taxing Profits in a Global Economy*, Oxford University Press, 2020, pp. 267-233. See also Joint Committee on Taxation, *Destination-Based Taxation and Border Adjustments* (JCX-20-17), May 22, 2017.

[7] Although U.S. courts extend comity to foreign judgments in some instances, they are not required to do so, and absent clear intent in legislative language, domestic law is presumed not to have extraterritorial effect. *Morrison v. National Australia Bank Ltd.*, 561 U. S. 247, 255 (2010).

including the promulgation of a model treaty,[8] a precursor of which was first developed by a predecessor organization in 1958, which in turn has antecedents from work by the League of Nations in the 1920s.[9] As a consensus document, the OECD model treaty is intended to aid countries in constructing their own bilateral treaties. The provisions have been revised and updated over time as practice with actual bilateral treaties leads to unexpected results and new issues are raised by parties to the treaties.[10] U.S. bilateral treaties generally are consistent with the OECD model treaty.

3. U.S. tax principles common to inbound and outbound taxation.

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

<u>Residence</u>

The Code defines a U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, trusts and estates.[11] Partnerships and corporations are domestic if organized or created under the laws of the United States, any State, or the District of Columbia, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[12] All other partnerships and corporations (*i.e.*, those organized under the laws of foreign countries) are foreign.[13] Other jurisdictions may use factors such as situs or management and control to determine residence. As a result, legal entities may have more than

[8] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, available at https://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm (last accessed July 12, 2023).

[9] See "Report by the Experts on Double Taxation," League of Nations Document E.F.S. 73\F19 (1923), which was a report commissioned by the League at its second assembly; see also Lara Friedlander and Scott Wilkie, "Policy Forum: The History of Tax Treaty Provisions—And Why It Is Important to Know About It," 54 *Canadian Tax Journal* No. 4 (2006).

[10] For example, the OECD initiated a multi-year study on base-erosion and profit shifting in response to concerns of multiple members. For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

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

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

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

one tax residence, or, in some cases, no residence. In such cases, bilateral treaties may resolve conflicting claims of residence.

Exception for corporate inversions

In certain cases, a foreign corporation that acquires a domestic corporation or partnership may be treated as a domestic corporation for Federal tax purposes.[14] This result generally applies following a transaction in which, pursuant to a plan or a series of related transactions:

1. a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;

2. the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (often referred to as "stock held by reason of"); and

3. the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (the "expanded affiliated group"), does not have substantial business activities in the entity's country of organization, compared to the total worldwide business activities of the expanded affiliated group.

If the "stock held by reason of" the acquisition is less than 80 percent, but at least 60 percent of the stock of the foreign corporation, and the other requirements above are satisfied, then the foreign corporation is not treated as a domestic corporation. Instead, the foreign corporation is considered a surrogate foreign corporation for the acquired domestic company, which is an expatriated entity that must recognize certain "inversion gain" post-acquisition restructuring[15] and may be subject to other consequences under the provisions enacted in 2017.[16]

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[14] Sec. 7874. The Treasury Department and the IRS have promulgated detailed guidance, through both regulations and several notices, addressing these requirements under section 7874 since its enactment in 2004, and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions.

[15] An excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Sec. 4985. In addition, dividends from certain surrogate foreign corporations are excluded from qualified dividend income within the meaning of section 1(h)(11)(B) and are ineligible to be taxed as net capital gains. Sec. 1(h)(11)(C)(iii). As a result, individual shareholders in such corporations cannot claim the reduced rate on dividends otherwise available under section 1(h)(11).

[16] See secs. 59A(d)(4) (providing that payments made to expatriated entities that reduce gross receipts are base erosion payments) and 965(l) (disallowing the partial participation exemption deduction for computing the transition tax and assessing the additional transition tax in the year of inversion if an entity inverts within the 10-year period beginning on December 22, 2017)).

Entity classification

Certain entities other than "*per se*" corporations[17] are eligible to elect their classification for Federal income tax purposes under the "check-the-box" regulations,[18] which affects the determination of the source of the income, availability of tax credits, and other tax attributes. Such business entity classifications include a corporation, a partnership, or an entity disregarded as separate from its owner (a "DRE").[19] In the case of a DRE owned by an individual, a DRE is treated in the same manner as a sole proprietorship, and in the case of a DRE owned by a corporation or partnership, in the same manner as a branch or division. Both foreign and domestic entities may make the election. As a result, an entity formed in the United States and operating in at least one other jurisdiction may be treated as a hybrid entity (*i.e.*, treated as a partnership or disregarded entity for U.S. tax purposes but as a corporation for foreign tax purposes) or a reverse hybrid entity (*i.e.*, treated as a corporation for U.S. tax purposes but as a partnership or disregarded entity for foreign tax purposes). These regulations were intended to relieve both taxpayers and the IRS from the need to expend considerable resources in determining the proper classification of unincorporated entities, when classification was effectively elective for well-advised taxpayers. Nevertheless, Treasury and the IRS recognized that such increased flexibility in entity classification in the foreign context could provide greater opportunities under existing regulations for inconsistent, or hybrid, entity classification in which an entity is treated as a taxable entity in one country but as a flow-through entity in another country.[20]

Source of income rules

Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor or recipient and the location of the activities or assets that generate the income. Extensive rules determine whether income is considered to be from U.S. sources or foreign sources.[21] Special rules are provided for certain industries, (*e.g.*, transportation, shipping, and certain space and ocean activities) as well as for income partly from within and partly from without the United States.[22]

While many rules for determining the source of income have remained unchanged over the years, changes made in 2017 by Public Law 115-97 address the sale of inventory by eliminating the title passage rule. Specifically, gains, profits, and income from the sale or

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[17] These corporations include incorporated domestic business entities, banks, insurance companies, and any entity included in a list of foreign business entities. Treas. Reg. sec. 301.7701-2(b).

[18] Treas. Reg. sec. 301.7701-1, *et seq*.

[19] Treas. Reg. sec. 301.7701-3.

[20] See Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

[21] Sections 861 through 865, generally.

[22] Sec. 863.

exchange of inventory property that is either (1) produced (in whole or in part) inside the United States and then sold or exchanged outside the United States or (2) produced (in whole or part) outside the United States and then sold or exchanged inside the United States is allocated and apportioned solely on the basis of the location of the production activities.[23] For example, income derived from the sale of inventory produced entirely in the United States is wholly from U.S. sources, even if title passage occurs elsewhere. Likewise, income derived from the sale of inventory produced entirely in another country is wholly from foreign sources, even if title passage occurs in the United States. If inventory is produced only partly in the United States, the income derived from its sale is sourced partly in the United States regardless of where title to the property passes.

Transfer pricing

General rule – arm's length standard

Section 482 authorizes the Secretary to allocate income, deductions, credits, or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance. Comprehensive Treasury regulations under that section generally adopt the arm's-length standard as the method for determining whether a particular allocation is appropriate.[24] Under that standard, the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in a similar transaction with unrelated parties bargaining at arm's length. The arm's-length standard is broadly accepted internationally, including all members of the OECD as well as many nonmembers.[25]

Special rules

Intangible property

Section 482 requires that the income with respect to a transfer of intangible property be commensurate with the income attributable to the intangible. By requiring inclusion of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[26]

[23] Sec. 863(b).

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

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

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

A U.S. person may transfer intangible property to a related person (typically, a foreign affiliate) in one of four ways: an outright transfer of the intangible property; a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate; the provision of a service by the U.S. person to the foreign affiliate using the intangible property, rather than a direct transfer of the property; and finally, a transfer by the U.S. person of intangible property through a qualified cost-sharing arrangement with one or more foreign affiliates, under which the participants make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable product or service. A qualified cost-sharing arrangement is an agreement between taxpayers under common control that satisfies the requirements prescribed under regulations.[27] The method of transfer may determine whether the applicable section is section 482 or section 367(d).[28]

Definition of intangible property

For purposes of section 482, intangible property is defined by reference to the provision governing gain recognition from outbound transfers of intangible property.[29] That provision includes a list of enumerated items that specifically include goodwill, going-concern value, and workforce-in-place. It also includes a residual category of "any item the value of which is not attributable to tangible property or the services of any individual." As a result, neither source nor amount of value is relevant in determining whether property in one of the other enumerated categories is within the scope of the definition.[30]

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

[28] Section 367(d) (described further in Part B.6) requires the use of transfer pricing principles in determining gain to be recognized from a transfer within the scope of that section. In addition, special rules may apply in the case of a U.S. taxpayer's transfer of property to a partnership with related foreign partners under sections 704(c) and 721(c) and the related regulations thereunder.

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

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

Valuation of intangibles

Section 482 provides that "[f]or purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers."[31] The mandated use of the aggregate basis valuation method in these cases under section 482 is consistent with regulations promulgated prior to the 2017 revision of the statute, which required that synergies created by the interrelated nature of intangible assets that are transferred in one or more contemporaneous transactions be properly taken into account in order to reach an arm's-length result.[32] The approach is also consistent with Tax Court's decisions in cases outside of the section 482 context, in which collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate,[33] as well as existing cost-sharing regulations.[34] Similarly, the realistic alternative principle is consistent with regulations[35] that pre-date inclusion in the statutory language, and is

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

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

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

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

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

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

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

Blocked income regulations

The IRS will respect, under limited exceptions, a foreign law proscription that limits cross-border payments when determining whether an arm's-length price was paid for cross-border goods or services (the "blocked income regulation").[36] In *3M Company and Subsidiaries v. Commissioner*,[37] the Tax Court upheld the validity of the regulation in a fully reviewed opinion with nine judges in the majority and eight dissenting. In doing so, the Court analyzed the conditions in the regulation for recognizing a foreign law prohibition. The blocked income regulation recognizes a foreign legal prohibition only if four requirements are met: (1) the foreign law or regulation was publicly promulgated, (2) it applies to both controlled and uncontrolled parties, (3) it prevents the payment in any form, and (4) the taxpayer has exhausted efforts to seek remedy under local law. The Court found that the foreign law prohibition in question failed both the first and second of those four requirements.

4. Recent U.S. developments

Corporate alternate minimum tax

For taxable years beginning after December 31, 2022, large C corporations meeting certain requirements ("applicable corporations") are subject to a new corporate alternative minimum tax that is based on adjusted financial statement income ("AFSI").[38] The tax equals the excess (if any) of (1) the tentative minimum tax for the taxable year, over (2) the regular tax (as defined in section 55(c)) plus the tax imposed by section 59A for the taxable year.[39] The tentative minimum tax for an applicable corporation for a taxable year is the excess of (i) 15 percent of the AFSI (as reduced by certain financial statement NOLs[40]) for the taxable year, over (ii) the book minimum tax foreign tax credit for such taxable year.[41] In the case of any

[36] Treas. Reg. sec. 1.482-1(h)(2).

[37] 160 T.C. No. 3 (February 9, 2023).

[38] See secs. 53(e), 55(b)(2), 56A and 59(k) and (l).

[39] Sec. 55(a).

[40] Solely for purposes of determining an applicable corporation's alternative minimum tax liability, AFSI is reduced by the lesser of the aggregate amount of financial statement NOL carryovers to the taxable year, or 80 percent of the AFSI computed without regard to the financial statement NOL deduction. Financial statement NOL carryovers are the amount of net loss (if any) set forth on the corporation's applicable financial statement for taxable years ending after December 31, 2019. See secs. 56A(d) (providing the AFSI deduction for a financial statement NOL) and 59(k)(1)(B) (disregarding the AFSI deduction for a financial statement NOL for purposes of determining whether a corporation meets the average annual AFSI test).

[41] Secs. 55(b)(2) and 59(l).

corporation that is not an applicable corporation, the tentative minimum tax for the taxable year is zero.[42]

Section 56A sets forth the general definition of AFSI, which is used for purposes of determining the corporate alternative minimum tax liability and, with certain modifications provided in section 59(k), for purposes of determining whether a corporation is an applicable corporation subject to the corporate alternative minimum tax. AFSI is the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement for such taxable year, adjusted as set forth in section 56A. Adjustments to net financial statement income include adjustments for: (1) statements covering different taxable years, (2) consolidated tax returns, (3) dividends and other amounts, (4) earnings of certain partnerships, (5) certain foreign income,[43] (6) certain Federal and foreign taxes, (7) income of disregarded entities, (8) patronage dividends and per-unit retain allocations of cooperatives, (9) certain items of Alaska Native Corporations, (10) amounts attributable to elections for direct payment of certain credits, (11) reasonable mortgage servicing income, (12) defined benefit pensions, (13) tax-exempt entities, (14) depreciation, and (15) qualified wireless spectrum.

The Secretary is directed to issue regulations to prevent the omission or duplication of any item, to address corporate organizations and reorganizations, and to address the effect of these provisions on partnerships with an applicable corporation as a partner.

In general, a corporation is an applicable corporation subject to the corporate alternative minimum tax if it meets the average annual AFSI test for one or more taxable years which are prior to such taxable year, and end after December 31, 2021.[44] A corporation meets such test for a taxable year if its average annual AFSI for the three-taxable-year period ending with such taxable year exceeds $1 billion. In the case of a foreign-parented corporation, there is an additional test requiring that the average annual AFSI of the corporation (not including income of the group not subject to U.S. tax) for the three-taxable-year period ending with such taxable year be $100 million or more. Aggregation rules and certain adjustments apply in determining AFSI for purposes of determining whether a corporation is an applicable corporation.[45]

General business credits generally may offset up to approximately 75 percent of the sum of a corporation's normal income tax and alternative minimum tax.[46] Any general business credit

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[42] Sec. 55(b)(2)(B).

[43] For example, in the case of a taxpayer that is a U.S. shareholder of one or more controlled foreign corporations ("CFCs"), the AFSI of such taxpayer with respect to such CFC is adjusted also to take into account such taxpayer's pro rata share of items taken into account in computing the net income or loss set forth on the CFC's applicable financial statement (as adjusted under rules similar to those that apply in determining AFSI). "Pro rata share" is determined under rules similar to the rules under section 951(a)(2). See new sec. 56A(c)(3)(A). See Part I.B. for a further discussion of U.S. shareholders and CFCs.

[44] Sec. 59(k).

[45] See sec. 59(k).

[46] Sec. 38.

in excess of this limitation generally may be carried back one year and forward up to 20 years.[47] In general, an applicable corporation is entitled for any taxable year to a credit against its Federal income tax in an amount equal to the minimum tax credit for such taxable year.[48]

[47] Sec. 39.

[48] Sec. 53(e).

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

In general, income earned directly by a U.S. person from the conduct of a foreign trade or business is taxed currently,[49] while income earned indirectly through certain related foreign entities (*i.e.*, controlled foreign corporations ("CFCs"))[50] is taxed in the year earned or not at all. Indirect earnings of CFCs are generally taxable in one of two ways. First, the earnings may constitute income to U.S. shareholders under the traditional anti-deferral regime of subpart F, which applies to certain passive income and income that is readily movable from one jurisdiction to another.[51] Subpart F was designed as an anti-abuse regime to prevent U.S. taxpayers from shifting passive and mobile income to low-tax jurisdictions.[52] Second, the earnings may be subject to section 951A, which applies to some foreign-source income of a CFC that is not subpart F income (referred to as global intangible low-taxed income ("GILTI")). GILTI was enacted as a base protection measure to counter the participation exemption system, established by the dividends-received-deduction, which was perceived as creating an incentive for U.S. corporations to allocate income to low- or zero-tax jurisdictions, where the income could potentially be distributed back to the U.S. corporation with no U.S. tax imposed.[53] Subpart F income is taxed at full rates with related foreign taxes generally eligible for the foreign tax credit; GILTI is taxed at preferential rates with additional limitations on the use of related foreign tax credits.[54] Both subpart F income and GILTI are included by the U.S. shareholder without regard to whether the earnings are distributed by the CFC.

Foreign earnings not subject to tax as subpart F income or GILTI generally are exempt from U.S. tax. To exempt those earnings, dividends received by corporate U.S. shareholders

[49] Such income is called foreign branch income.

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

[51] Subpart F comprises sections 951 through 965.

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

[53] See S. Prt. No. 115-20, Reconciliation Recommendations Pursuant to H. Conf. Res. 71 (2017).

[54] The reduced rate for GILTI was enacted because there was a recognition that taxing the income at the full U.S. corporate tax rate may hurt the competitive position of U.S. corporations relative to their foreign counterparts, which were not subject to a similar tax. See Reconciliation Recommendations Pursuant to H. Con. Res. 71 (December 2017).

from specified 10-percent owned foreign corporations (including CFCs) generally are eligible for a 100-percent dividends-received deduction ("DRD").[55]

In addition to the taxation of GILTI at preferential rates, U.S. corporations generally are taxed at preferential rates on their foreign-derived intangible income ("FDII").[56]

1. Subpart F income

Under subpart F, U.S. shareholders of a CFC must include in income their *pro rata* shares of subpart F income, without regard to whether the income is distributed to the shareholders.[57] In effect, U.S. shareholders of a CFC are treated as having received a current distribution of the CFC's subpart F income. With exceptions described below, subpart F income generally includes passive income and other related party income that is readily movable from one jurisdiction to another. Subpart F income consists of foreign base company income,[58] insurance income,[59] and certain income relating to international boycotts and other violations of public policy.[60]

Foreign base company income

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, as well as certain categories of income from business operations, including foreign base company sales income and foreign base company services income.[61]

Foreign personal holding company income

Foreign personal holding company income ("FPHCI") generally includes income from dividends, interest, royalties, rents, annuities; net gains on certain property transactions; net gains from commodities transactions; net gains from foreign currency transactions; income equivalent to interest; income from notional principal contracts; payments in lieu of dividends; and amounts received under certain personal service contracts.[62]

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

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

[57] Sec. 951(a).

[58] Secs. 952(a)(2) and 954.

[59] Secs. 952(a)(1) and 953.

[60] Sec. 952(a)(3)-(5).

[61] Sec. 954.

[62] Sec. 954(c)(1)(A)-(H).

Several exceptions apply to exclude certain income from FPHCI. For example, FPHCI does not include certain dividends, interest, rents, and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.[63] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. Another exception excludes from FPHCI dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC to the extent attributable or properly allocable to income of the payor that is not subpart F income.[64]

In addition, there is an "active business" exception for rents and royalties that are derived from an active trade or business conducted by the CFC and not received from a related party.[65] In general, payments by a branch to its owner are disregarded. Thus, in this context, royalty payments by a branch to its CFC owner are disregarded. A branch may include a foreign entity that has elected for U.S. Federal tax purposes to be disregarded as an entity separate from its CFC owner (*i.e.*, a DRE).

Foreign base company sales income

Foreign base company sales income ("FBC sales income") is income derived by a CFC in connection with (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. These rules for FBC sales income were intended to subject certain sales income to U.S. tax, because sales income was viewed as a type of highly mobile income, unlike manufacturing income.[66]

There are several exceptions to FBC sales income, including the same country manufacturing exception, same country sales or use exception, and the CFC manufacturing exception. In each of the situations described in items (1) through (4) above, the property must be both manufactured and sold for use outside the country in which the CFC is organized for the income from its sale to be considered FBC sales income.[67] The same country manufacturing exception excludes from FBC sales income any income from the sale of goods manufactured in the country in which the CFC is organized.[68] The same country sales or use exception excludes

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[63] Sec. 954(c)(3).

[64] Sec. 954(c)(6). This exception, colloquially referred to as the CFC look-through rule, applies to taxable years of foreign corporations beginning before January 1, 2026, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

[65] Sec. 954(c)(2)(A).

[66] See H.R. Rpt. No. 87-1447 (providing that "the sales income with which your committee is primarily concerned is income of a selling subsidiary … which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income.").

[67] Sec. 954(d)(1).

[68] Sec. 954(d)(1)(A).

from FBC sales income any income from the sale of goods for the use, consumption, or disposition in the country in which the CFC is organized.[69]

A second manufacturing exception (*i.e.*, the CFC manufacturing exception), which is set forth in regulations, provides that FBC sales income does not include income from the sale of property that the CFC manufactures, purchases, or sells outside the country in which the CFC is organized if the CFC does not violate the branch rule (discussed below).[70] Manufacturing is defined by physical manufacturing tests such as the substantial transformation test and the substantial activity test, as well as nonphysical activities such as the substantial contribution test.[71]

Manufacturing, purchasing, and selling through branches

To qualify for the CFC manufacturing exception, a CFC that manufactures, purchases, or sells outside its country of organization through a branch must satisfy the "branch rule." Under the branch rule, a CFC must show (in effect) that the use of the branch is not to move income from a high-tax jurisdiction to a low-tax jurisdiction. The branch rule provides that, if a CFC manufactures, purchases, or sells through a branch outside its country of organization and the use of the branch has "substantially the same effect" as would the use of a wholly owned subsidiary corporation of the CFC, then the branch and the CFC are treated as separate corporations for purposes of determining FBC sales income of the CFC.

The use of the branch has "substantially the same effect" if a tax rate disparity test is met. The test looks to whether the tax rate of the branch is too low in comparison to that of the CFC. Under the sales branch rule, the test looks to whether the tax rate of the sales branch is too low in comparison to the CFC (where the manufacturing is).[72] Under the manufacturing branch rule, the test looks to whether the tax rate of the CFC (where the sales are) is too low in comparison to the tax rate that the jurisdiction of the manufacturing branch would apply to that income.[73] If the relevant tax rate (under either test) is too low, then the related income is FBC sales income.

[69] Sec. 954(d)(1)(B).

[70] Treas. Reg. sec. 1.954-3(a)(2).

[71] Under the substantial transformation test, a CFC is considered to have manufactured a product if the CFC purchases and substantially transforms personal property prior to its sale, such as processing and converting wood pulp into paper. Treas. Reg. sec. 1.954-3(a)(4)(ii). Under the substantial activity test, a CFC is considered to have manufactured a product through the assembly or conversion of component parts, provided the activities are substantial in nature. Treas. Reg. sec. 1.954-3(a)(4)(iii). Under the substantial contribution test, a CFC does not have FBC sales income if the CFC engages in certain activities, such as oversight and direction of manufacturing activities, vendor selection, and quality control, that make a substantial contribution to the manufacturing process. Treas. Reg. sec. 1.954-3(a)(4)(iv).

[72] Treas. Reg. sec. 1.954-3(b)(1)(i)(b).

[73] Treas. Reg. sec. 1.954-3(b)(1)(ii)(b).

Foreign base company services income

Foreign base company services income ("FBC services income") is income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which (1) are performed for or on behalf of any related person, and (2) are performed outside the country in which the CFC is organized.[74] These FBC services income rules were intended to discourage U.S. corporations from separating mobile services income into a low-tax jurisdiction.

FBC services income does not include income derived in connection with the performance of services which are directly related to (1) the sale or exchange by the CFC of property manufactured, produced, grown, or extracted by the CFC and which are performed before the time of the sale or exchange, or (2) an offer or effort to sell or exchange such property.[75]

Insurance income

Insurance income subject to current inclusion under subpart F includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization.[76]

Investments in U.S. property

U.S. shareholders also must include their pro rata shares of a CFC's untaxed earnings invested in certain items of U.S. property.[77] For this purpose, U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[78] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[79]

Other exceptions

An exception to foreign base company income and insurance income (the "high-tax exception") is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the

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[74] Sec. 954(e)(1).

[75] Sec. 954(e)(2). Other exceptions apply for income otherwise excluded from subpart F income.

[76] Sec. 953(a) and (e).

[77] Secs. 951(a)(1)(B) and 956.

[78] Sec. 956(c)(1).

[79] Sec. 956(c)(2).

maximum U.S. corporate income tax rate in effect at the time the income was earned (*e.g.*, for income earned by a CFC in tax year 2022, more than 90 percent of 21 percent, or 18.9 percent).[80]

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[81] With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business, to conduct substantial activity with respect to such business, and to meet other specified requirements.

For a securities dealer, foreign personal holding company income excludes any interest or dividend (or certain equivalent amounts) from any transaction entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475.[82]

Exclusion of previously taxed earnings and profits

A U.S. shareholder may exclude from its income actual distributions of earnings and profits from a CFC that were previously included in income by the U.S. shareholder under subpart F.[83] Any income inclusion resulting from an investment in U.S. property also may be excluded when such earnings and profits are ultimately distributed.[84]

Basis adjustments

A U.S. shareholder of a CFC generally increases the basis in its CFC stock by the amount of subpart F income inclusions and generally reduces the basis in its CFC stock by the amount of any distributions that are excluded from its income as previously taxed earnings and profits.[85]

2. GILTI

A U.S. shareholder of a CFC also must include in gross income its GILTI. GILTI is the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return equals the excess of 10 percent of the aggregate of its *pro rata* share of the qualified business asset investment ("QBAI") of each CFC over certain interest expense.[86]

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[80] Sec. 954(b)(4); see also Treas. Reg. Sec. 1.954-1(d).

[81] Sec. 954(h).

[82] Sec. 954(c)(2)(C).

[83] Sec. 959(a)(1).

[84] Secs. 959(a)(2) and 956.

[85] Sec. 961.

[86] The interest expense that reduces a U.S. shareholder's net deemed tangible income return is that which is taken into account in determining its net CFC tested income for the taxable year to the extent that the interest

The formula for GILTI is:

$$GILTI = Net\ CFC\ Tested\ Income - [(10\% \times QBAI) - Interest\ Expense]$$

Although a GILTI inclusion is generally treated in the same manner as a subpart F inclusion, GILTI is not subpart F income.[87] GILTI is computed at the U.S.-shareholder level rather than the CFC level, with a U.S. shareholder allowed to offset tested income of its CFCs with tested loss of other CFCs in computing net CFC tested income. When computing tax liability associated with GILTI, U.S. shareholders may not take into account certain tax attributes of CFCs with tested loss, such as foreign tax credits and QBAI. In addition, the foreign tax credit limitation is applied separately with respect to GILTI, and no carryovers and carrybacks of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Net CFC tested income

Net CFC tested income means the excess of the aggregate of the shareholder's *pro rata* share of the tested income of each CFC over the aggregate of its *pro rata* share of the tested loss of each CFC.[88]

The tested income of a CFC is the excess of the gross income of the CFC determined without regard to certain amounts that are exceptions to tested income (referred to thereinafter as "gross tested income") over deductions (including taxes) properly allocable to such gross tested income. The exceptions to tested income are: (1) any effectively connected income described in section 952(b); (2) any gross income taken into account in determining the CFC's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4)[89]; (4) any dividend received from a related person (as defined in section 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in section 907(c)(1)).

The tested loss of a CFC means the excess of deductions (including taxes) properly allocable to the CFC's gross tested income over the amount of such gross tested income.

income attributable to such interest expense is not taken into account in determining the shareholder's net CFC tested income.

[87] Sec. 951A(f).

[88] Sec. 951A(c)(1). *Pro rata* shares are determined under subpart F principles (*i.e.*, the rules of section 951(a)(2) and the regulations thereunder).

[89] See also Treas. Reg. secs. 1.951A-2(c)(1)(iii) and (c)(7) (providing an election to apply the high-tax exception described in section 954(b)(4) to exclude from tested income of a CFC any gross income of such CFC that is subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11).

Qualified business asset investment

QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of the CFC's adjusted bases in specified tangible property that is both used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167.[90] The adjusted basis in any property generally must be determined using the alternative depreciation system under section 168(g) as in effect on December 22, 2017.

Specified tangible property generally means any tangible property used in the production of tested income.[91]

Treatment as subpart F income

GILTI inclusions generally are treated in the same manner as amounts included as subpart F income.[92]

Preferential rate on GILTI

The preferential rate on GILTI is achieved by allowing corporations a deduction equal to 50 percent[93] of their GILTI (including the corresponding section 78 gross-up amount).[94]

3. Foreign-derived intangible income ("FDII")

In 2017, Congress enacted rules relating to foreign-derived intangible income ("FDII") with the intent of encouraging U.S. companies to own valuable intangible assets and earn intangible income in the United States, rather than in low- or zero-tax jurisdictions.[95] Domestic corporations generally are taxed at preferential rates on their FDII.[96] The preferential rate is

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[90] Sec. 951A(d)(1).

[91] Sec. 951A(d)(2). If tangible property is used to produce both tested income and income other than tested income ("dual-use property"), a proportionate amount of such property is treated as specified tangible property. Specified tangible property does not include property used in the production of tested loss; thus, a CFC with a tested loss in a taxable year does not have QBAI for such taxable year.

[92] Sec. 951A(f)(1).

[93] For taxable years beginning after December 31, 2025, the deduction for GILTI is reduced to 37.5 percent. Sec. 250(a)(3)(B). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on GILTI is 10.5 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on GILTI rises to 13.125 percent.

[94] Sec. 250(a)(1)(B). Under section 78, a taxpayer claiming the foreign tax credit with respect to foreign-source income generally must include in income the amount of the related foreign taxes paid.

[95] See S. Prt. No. 115-20, Reconciliation Recommendations Pursuant to H. Conf. Res. 71 (2017).

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

achieved by allowing corporations a deduction equal to 37.5 percent of their FDII.[97] FDII is calculated by multiplying a corporation's "deemed intangible income" by the percentage of its "deduction eligible income" that is derived from serving foreign markets (*i.e.*, "foreign-derived deduction eligible income").[98] A corporation's deemed intangible income equals the excess, if any, of its deduction eligible income over a 10-percent return on its qualified business asset investment ("QBAI").[99] The formula for FDII can be expressed as the following:

$$FDII = [Deduction\ Eligible\ Income - (10\% \times QBAI)] \times \frac{Foreign\ Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

For purposes of computing FDII, a domestic corporation's QBAI is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is allowable under section 167.[100]

<u>Deduction eligible income and foreign-derived deduction eligible income</u>

Deduction eligible income means, with respect to any domestic corporation, the excess (if any) of the gross income of the corporation determined without regard to certain amounts that are excluded from deduction eligible income (referred to in this document as "gross deduction eligible income") over deductions (including taxes) properly allocable to such gross income.[101]

Foreign-derived deduction eligible income means, with respect to a taxpayer for its taxable year, any deduction eligible income of the taxpayer that is derived in connection with

[97] For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent. Sec. 250(a)(3)(A). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on FDII is 13.125 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on FDII is 16.406 percent.

[98] Sec. 250(b)(1).

[99] Sec. 250(b)(2). If the quantity in this formula is negative, deemed intangible income is zero.

[100] The definition of QBAI for purposes of computing FDII relies on the definition of QBAI for purposes of computing GILTI under section 951A(d), determined by substituting "deduction eligible income" for "tested income" in section 951A(d)(2) and without regard to whether the corporation is a CFC. Sec. 250(b)(2)(B). Thus, specified tangible property for purposes of computing FDII means any tangible property used in the production of deduction eligible income. For this reason, the adjusted basis of depreciable tangible property held by a foreign branch generally is excluded from QBAI because foreign branch income is excluded from gross deduction eligible income.

[101] Sec. 250(b)(3)(A). The amounts excluded from deduction eligible income are: (1) subpart F income; (2) GILTI; (3) financial services income; (4) any dividend received from a CFC with respect to which the corporation is a U.S. shareholder; (5) any domestic oil and gas extraction income of the corporation; and (6) any foreign branch income.

(1) property that is sold[102] by the taxpayer to any person who is not a U.S. person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use[103] or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States.[104]

Foreign use means any use, consumption, or disposition that is not within the United States.[105] Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or to certain related parties.[106]

Taxable income limitation

If the sum of a domestic corporation's FDII and GILTI (including GILTI-attributable section 78 gross-up amounts) exceeds its taxable income determined without regard to section 250, then the amount of FDII and GILTI (including GILTI-attributable section 78 gross-up) for which a deduction is allowed is reduced (but not below zero) by an amount determined by such excess.

4. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed a credit for foreign income taxes they pay. In addition, a domestic corporation is allowed a credit for foreign income taxes paid by a CFC with respect to income included by the corporation as subpart F income and GILTI; such taxes are deemed to have been paid by the domestic corporation for purposes of calculating the foreign tax credit.[107]

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

[102] For purposes of determining FDII, the terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. Sec. 250(b)(5)(E).

[103] If property is sold by a taxpayer to a person who is not a U.S. person and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.

[104] Sec. 250(b)(4).

[105] Sec. 250(b)(5)(A).

[106] Sec. 250(b)(5)(B) and (C).

[107] Secs. 901, 903 and 960; see also secs. 1291(g) and 1293(f) (providing, in the PFIC context, coordination with foreign tax credit rules). On January 4, 2022, Treasury published final regulations relating to the foreign tax credit, which included modifications to the requirements for determining whether a foreign levy qualifies as a foreign income tax for purposes of section 901 or a tax in lieu of an income tax for purposes of section 903. T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022). These modifications include changes to the net gain requirement, which incorporates an additional attribution requirement. See also Treas. Reg. secs. 1.901-2 and 1.903-1.

of foreign-source income without offsetting U.S. tax on U.S.-source income.[108] The limit is computed by multiplying a taxpayer's total pre-credit U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may (in certain cases) carry back the excess foreign taxes to the previous year and then carry forward any remaining excess to one of the 10 succeeding taxable years.[109] No carryback or carryover of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Deemed-paid taxes

For any subpart F income included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to the aggregate foreign income taxes paid or accrued with respect to such income by the CFC.

For any GILTI included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to 80 percent of the corporation's inclusion percentage multiplied by the aggregate foreign income taxes paid or accrued with respect to tested income (but not tested loss) by each CFC with respect to which the domestic corporation is a U.S. shareholder.[110]

Allocation and apportionment of expenses

To determine its foreign tax credit limitation, a taxpayer must first determine its taxable income from foreign sources by allocating and apportioning deductions between U.S.-source gross income and foreign-source gross income in each limitation category. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[111] However, subject to certain exceptions, deductions for interest expense, stewardship expenses, and research and experimental expenses are apportioned based on certain ratios.[112] For example, interest expense is apportioned based on the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets.[113]

[108] Secs. 901 and 904.

[109] Sec. 904(c).

[110] Sec. 960(d)(1). The inclusion percentage means, with respect to any domestic corporation, the ratio of such corporation's GILTI divided by the aggregate amount of its *pro rata* share of the tested income (but not tested loss) of each CFC with respect to which it is a U.S. shareholder. Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).

[111] Treas. Reg. sec. 1.861-8(b) and (c) and Temp. Treas. Reg. sec. 1.861-8T(c).

[112] Treas. Reg. sec. 1.861-8 through Temp. Treas. Reg. sec. 1.861-14T and Treas. Reg. sec. 1.861-17 set forth detailed rules relating to the allocation and apportionment of expenses.

[113] Sec. 864(e)(2).

Limitation categories ("baskets")

The foreign tax credit limitation is applied separately to GILTI, foreign branch income,[114] passive category income, and general category income.[115] For this purpose, GILTI and foreign branch income include only income that is not passive category income. Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income.[116] All other income is in the general category. Passive income is treated as general category income if earned by a qualifying financial services entity or if highly taxed (*i.e.*, if the foreign tax rate is determined to exceed the highest tax rate specified in section 1 or 11, as applicable).[117] Dividends (and subpart F inclusions), interest, rents, and royalties received by a U.S. shareholder from a CFC are assigned to the passive category to the extent the payments or inclusions are allocable to passive category income of the CFC.[118] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[119]

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.[120] Foreign losses from one category first offset foreign-source income from other categories. Any remaining overall foreign loss offsets U.S.-source income. The same principle applies to losses from U.S. sources. In subsequent years, any losses deducted against another category or source of income are recaptured. That is, an equal amount of income from the same category or source that generated a loss in a prior year is recharacterized as income from the other category or source against which the loss was deducted. Foreign-source income in a particular category may be fully recharacterized as income in another category, whereas only up to 50 percent of income from one source in any subsequent year may be recharacterized as income from the other source.

A taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus

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[114] Foreign branch income is defined for this purpose as "the business profits of [the U.S. taxpayer] which are attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries." Sec. 904(d)(2)(J).

[115] Sec. 904(d); Treas. Reg. sec. 1.904-4(a). The foreign tax credit limitation is also applied separately to certain additional separate categories. See Treas. Reg. sec. 1.904-4(m).

[116] Sec. 904(d)(2)(A)(i) and (B).

[117] Sec. 904(d)(2)(B).

[118] Sec. 904(d)(3).

[119] Sec. 904(d)(4).

[120] Sec. 904(f) and (g).

no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[121]

5. Dividends-received deduction ("DRD")

As discussed above, income earned indirectly through CFCs is taxed either in the year earned (as subpart F income or GILTI) or not at all. Distributions of previously taxed earnings and profits do not constitute dividends.[122]

A domestic U.S. shareholder generally is allowed a 100-percent DRD for the foreign-source portion of dividends received from a specified 10-percent owned foreign corporation,[123] provided that certain holding period requirements are satisfied.[124] A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder.[125]

The term "dividend received" is intended to be interpreted broadly, consistent with the meaning of the phrases "amount received as dividends" and "dividends received" under sections 243 and 245, respectively. The DRD is not available for any hybrid dividend.[126]

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD.[127] Further, no foreign tax credit or deduction is allowed

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[121] Sec. 909.

[122] Sec. 959(d).

[123] Sec. 245A(a). The foreign-source portion of any dividend equals the amount of the dividend multiplied by the percentage of undistributed earnings that are attributable to neither income that is "effectively connected" with the conduct of a U.S. trade or business ("ECI") nor certain dividends received from domestic corporations. Sec. 245A(c).

[124] A domestic corporation is not permitted a DRD in respect of any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, the holding period requirement is satisfied only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the taxpayer is a U.S. shareholder with respect to such specified 10-percent owned foreign corporation at all times during the period. Sec. 246(c)(5).

[125] Sec. 245A(b); see also sec. 951(b) (providing that a domestic corporation is a U.S. shareholder of a foreign corporation if it owns, within the meaning of section 958(a), or is considered as owning by applying the rules of section 958(b), 10 percent or more of the vote or value of the foreign corporation).

[126] A hybrid dividend is an amount received from a CFC for which section 245A(a) would allow a DRD and for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States. Sec. 245A(e)(4).

[127] Sec. 245A(d). For purposes of computing the foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must determine its foreign-source taxable income (and entire taxable income) by disregarding: (1) any dividend for which the DRD is taken and (2) any deductions properly allocable or apportioned to (A) income (other than amounts includible under section 951(a)(1)

for any taxes paid or accrued with respect to the U.S.-source portion of any dividend received by a domestic corporation from a qualified 10-percent owned foreign corporation.[128]

6. Gain recognition on outbound transfers of property

Special rules apply in situations in which a U.S. person transfers property to a foreign corporation in connection with certain nonrecognition transactions.[129] The rules were enacted as a way to curtail the transfer of property from U.S. taxpayers to foreign affiliates without the recognition of gain, in situations that posed the possibility of tax avoidance. As an example of the concern at that time, if a U.S. corporation held an asset with low basis but a high value, the corporation could sell that asset for a gain, which would be subject to U.S. corporate tax on that gain. However, if the U.S. corporation transferred the asset to a foreign subsidiary in a tax-free nonrecognition transaction, and the foreign subsidiary sold that asset, the arrangement could be structured such that the gain would not be subject to U.S. tax.

In order to address these structures, unless an exception applies, gain may be recognized on certain outbound transfers of property even if the transfer would otherwise qualify for nonrecognition (*e.g.*, section 351, 354, 356, or 361).[130] Such gain (and the character and source of such gain) must be determined as if the property had been disposed of in a taxable exchange.

If intangible property is transferred to a foreign affiliate in connection with certain corporate transactions (*e.g.*, section 351 or 361), nonrecognition rules that may otherwise apply are suspended. The transferor of intangible property must recognize gain from the transfer as though the transferor had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity, or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or upon disposition of the property after the transfer.[131] The appropriate amounts of those imputed payments are determined using transfer-pricing principles.

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or 951A(a)) with respect to stock of such foreign corporation, or (B) the stock to the extent income with respect to the stock is other than amounts includible under section 951(a)(1) or 951A(a). Sec. 904(b)(4).

[128] Sec. 245(a)(8).

[129] Sec. 367.

[130] Section 367 also provides rules relating to certain transactions in which there is no transfer of property described in section 367(a)(1), as well as transactions involving certain distributions and liquidations by domestic corporations. See sec. 367(b) (providing that in the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes) and (e) (addressing the treatment of any distribution described in section 355 by a domestic corporation to a foreign person and the treatment of any section 332 liquidation into a foreign parent corporation).

[131] Sec. 367(d). Section 367, as well as the regulations and other guidance promulgated thereunder, has evolved over time. For example, Public Law 115-97 repealed the active trade or business exception set forth in section 367(a)(3) for transfers after December 31, 2017, and Treasury has exercised its authority to issue guidance

7. Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act ("FATCA") was enacted in 2009.[132] Under FATCA, a withholding tax is imposed equal to 30 percent of the gross amount of withholdable payments[133] to a foreign financial institution and other foreign entities, unless the foreign entity meets certain reporting requirements with respect to its U.S. account holders or U.S. owners. Generally, withholding is required on withholdable payments unless the foreign financial institution ("FFI") enters into an FFI agreement with the Secretary or complies with an intergovernmental agreement ("IGA"). Under such agreements, the institutions or entities agree to obtain information necessary to determine whether any account at such institution is held or owned by U.S. persons,[134] as well as to report annually with respect to any such financial accounts, in addition to seeking waivers of local law that would otherwise bar reporting to the United States and complying with other requirements that the Secretary may determine are needed. An FFI must report with respect to a U.S. account (1) the name, address, and taxpayer identification number of each U.S. person holding an account or a foreign entity with one or more substantial U.S. owners holding an account; (2) the account number; (3) the account balance or value; and (4) except as provided by the Secretary, the gross receipts, including from dividends and interest, and gross withdrawals or payments from the account.[135]

FATCA regulations define withholdable payments as U.S. source "fixed or determinable annual or periodical gains, profits, and income ("FDAP income"), and, potentially in the future, gross proceeds from the sale or other disposition of any property of a type that can product interest or dividends that are U.S. source FDAP income. [136]

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on a number of occasions in an effort to address certain transactions (see, *e.g.*, Notice 2016-73, 2016-52 I.R.B. 908 (Dec. 2, 2016)). In addition, on May 2, 2023, Treasury issued proposed regulations that would provide that subsequent repatriations of intangible property made to certain U.S. persons and that complies with certain reporting requirements would no longer be subject to section 367(d). REG-124064-19, 88 Fed. Reg. 27819, May 2, 2023.

[132] The Hiring Incentives to Restore Employment ("HIRE") Act, Pub. L. No. 111-147. Subtitle A of Title V of the HIRE Act, entitled "Foreign Account Tax Compliance," was based on legislative proposals in the Foreign Account Tax Compliance Act ("FATCA"), a bill introduced in both the House and Senate on October 27, 2009, as H.R. 3933 and S. 1934, respectively. FATCA added new Chapter 4 to Subtitle A of the Code.

[133] Section 1473(1) broadly defines "withholdable payments" to include FDAP and gross proceeds from sales of property that produce interest or dividends from sources within the United States, except to the extent otherwise provided by the Secretary. Proposed regulations remove gross proceeds from the scope of "withholdable payment." Prop. Treas. Reg. sec. 1.1473-1(a), REG-132881-17, 83 Fed. Reg. 64757, December 18, 2018. Although the regulations are not final, the preamble provides that taxpayers may rely upon the proposed exclusion.

[134] A United States account is any financial account held by one or more specified United States persons or United States owned foreign entities. Sec. 1471(d). Depository accounts are not treated as United States accounts for these purposes if (1) each holder of the account is a natural person, and (2) the aggregate value of all depository accounts held (in whole or in part) by each holder of the account maintained by the financial institution does not exceed $50,000. Sec. 1471(d)(1)(B).

[135] Sec. 1471(c).

[136] Treas. Reg. sec. 1.1473-1(a)(1)(i).

An FFI is generally any non-U.S. entity that functions as a financial institution, a custodial institution that holds financial assets for third parties, investment entity, or insurance company. If any entity is not included in the definition of an FFI, the entity would generally be considered a non-financial foreign entity ("NFFE"). An NFFE other than an excepted NFFE is also required to provide its withholding agent with information on any substantial U.S. owners, or if none exist, a certification stating that fact. Excepted NFFE's include publicly traded corporations as well as active NFFE's that conduct an actual business activity other than holding assets that produce investment income.

An FFI that has not entered into an FFI agreement with the Secretary generally complies with its obligations under the terms of a bilateral IGAs between its country of residence and the United States. These agreements conform to one of two types. Under Model 1, an FFI fulfills its FATCA reporting obligations by reporting information about U.S. accounts directly to their domestic tax authority rather than to the IRS. The information is then the subject of an automatic exchange of information on a government-to-government basis between the two jurisdictions. This exchange of information may be reciprocal, pursuant to which both the foreign jurisdiction and the United States share information on U.S. and foreign account holders with each other, or may be nonreciprocal, in which case only the foreign jurisdiction shares information on U.S. account holders with the United States. IGAs based on Model 2 require that FFIs report specified information directly to the IRS and may be supplemented by a government-to-government exchange of information on request. The United States has entered into such agreements with over 100 jurisdictions, enabling the government to implement FATCA widely.[137]

On April 4, 2014, the Secretary and the IRS announced that jurisdictions with which the United States has reached agreement on an IGA in substance will be treated as if the agreement is in effect. In order to address concerns by FFIs in these jurisdictions, many of which had local law prohibitions on disclosing account holders, FFIs resident in, or organized under the laws of, a jurisdiction listed on the Treasury and IRS websites as having reached an agreement in substance were permitted to register on the FATCA registration website for a global identification number ("GIIN") and permitted to certify this status to a withholding agent consistent with this treatment.[138]

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[137] For a complete list of jurisdictions and links to the relevant agreements, see https://home.treasury.gov/policy-issues/tax-policy/foreign-account-tax-compliance-act (last accessed July 14, 2023).

[138] Announcement 2014-17, 2014-18 I.R.B. 1001. See also Announcement 2014-38, 2014-51 I.R.B. 951, and Announcement 2016-27, 2016-33 I.R.B. 238.

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

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

Finally, certain U.S. corporations with foreign affiliates are subject to a base erosion and anti-abuse tax ("BEAT") that is in the nature of a minimum tax and payable in addition to all other tax liabilities.[139]

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

FDAP income received by foreign persons from U.S. sources is subject to a 30-percent gross-basis tax (*i.e.*, a tax on gross income without reduction for related expenses), which is collected by withholding at the source of the payment. FDAP income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments.[140] The items enumerated in defining FDAP income are illustrative, and the words "annual or periodical" are "merely generally descriptive" of the payments within the purview of the statute.[141] The categories of income subject to the 30-percent tax and the categories for which withholding is required generally are coextensive.[142]

Exclusions from FDAP income

FDAP income encompasses a broad range of gross income but has important exceptions. Capital gains of nonresident aliens generally are foreign source; however, capital gains of nonresident aliens present in the United States for 183 days or more[143] during the year are income from U.S. sources subject to gross-basis taxation.[144] In addition, U.S-source gains from

[139] Sec. 59A.

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

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

[142] See secs. 1441 and 1442.

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

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

the sale or exchange of intangibles are subject to tax and withholding if they are contingent on the productivity, use, or disposition of the property sold.[145]

Interest on bank deposits may qualify for exemption from treatment as FDAP income on two grounds. First, interest on deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, is U.S.-source income but is exempt from the 30-percent tax when paid to a foreign person.[146] Second, interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not U.S.-source income and, thus, is not subject to U.S. tax.[147] Interest and original issue discount on certain short-term obligations also is exempt from U.S. tax when paid to a foreign person.[148] In addition, an exception to information reporting requirements may apply with respect to payments of such exempt amounts.[149]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30-percent gross-basis tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[150] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[151] certain contingent interest,[152] interest received by a CFC from a related person,[153] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[154]

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

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

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

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

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

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

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

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

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

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

Withholding of 30-percent gross-basis tax

The 30-percent tax on FDAP income is generally collected by means of withholding.[155] Withholding on FDAP payments to foreign payees is required unless the withholding agent (*i.e.*, the person making the payment to the foreign person) can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[156]

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

To the extent that a withholding agent withholds an amount, the withheld tax is credited to the foreign recipient of the income.[157] If the agent withholds more than is required, and that results in an overpayment of tax, the foreign recipient may file a claim for refund.

2. Net-basis taxation of U.S.-source income

ECI generally is subject to tax on a net basis under the same U.S. tax rules and rates that apply to business income earned by U.S. persons.[158]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in a U.S. trade or business if the partnership, estate, or trust is so engaged.[159]

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

[155] Secs. 1441 and 1442.

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

[157] Sec. 1462.

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

[159] Sec. 875.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.[160] Detailed rules govern whether trading in stock or securities, or in commodities, constitutes the conduct of a U.S. trade or business.[161] A foreign person who trades in stock or securities, or in commodities, in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities, or commodities, for the person's own account also generally is not considered to be engaged in a U.S. trade or business so long as the foreign person is not a dealer in stock or securities, or in commodities. This may be the case even in the presence of an office or fixed place of business in the United States through which trades for the person's own account are carried out.

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

Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on ECI from that trade or business. Specific statutory rules govern whether income is ECI.[162]

In general, for a foreign person engaged in the conduct of a U.S. trade or business, all income, gain, or loss from sources within the United States is treated as ECI.[163]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross-basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business, and whether the activities of the U.S. trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[164] Under the asset use and business activities tests, due regard is given to whether such asset or such income, gain, deduction, or loss was accounted for through the trade or business.

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[160] Sec. 864(b).

[161] Sec. 864(b)(2) and Treas. Reg. sec. 1.864-2(c) and (d).

[162] Sec. 864(c).

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

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

A foreign person that is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[165] A foreign tax credit may be allowed with respect to foreign income tax imposed on such income.[166] Foreign-source income not included in one of those categories generally is exempt from U.S. tax.

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which the agent regularly fills orders on behalf of the foreign person.[167] If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office is a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss is derived.[168]

Certain sales and other dispositions

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[169] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the income or gain is ECI if the income or gain would have been ECI in the prior year.[170] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the income or gain attributable to the disposition of the property is ECI if the income or gain would have been ECI

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

[166] See sec. 906.

[167] Sec. 864(c)(5)(A).

[168] Sec. 864(c)(5)(B).

[169] Sec. 864(c)(1)(B).

[170] Sec. 864(c)(6).

had the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business.[171]

Allowance of deductions

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

3. Base erosion and anti-abuse tax

The base erosion and anti-abuse tax (the "BEAT") is an additional tax imposed on certain multinational corporations with respect to payments to foreign affiliates.[172]

The BEAT applies only to corporate taxpayers with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year in excess of $500 million, and is determined, in part, by the extent to which a taxpayer has made payments to foreign related parties.[173] The BEAT generally does not apply to taxpayers for which reductions to taxable income ("base erosion tax benefits") arising from payments to foreign related parties ("base erosion payments") are less than three percent of total deductions (*i.e.*, a "base erosion percentage" of less than three percent).[174]

For a taxpayer subject to the BEAT (an "applicable taxpayer"), the additional tax (the "base erosion minimum tax amount" or "BEAT liability") for the year generally equals the excess, if any, of 10 percent of its modified taxable income over an amount equal to its regular tax liability reduced (but not below zero) by the sum of a certain tax credits.[175]

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[171] Sec. 864(c)(7).

[172] Sec. 59A.

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

[174] Sec. 59A.

[175] Sec. 59A(e).

Base erosion tax benefits and base erosion payments

A base erosion tax benefit generally reflects the reduction in taxable income arising from the associated base erosion payment.

A base erosion payment generally is any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable.[176] A base erosion payment includes any amount paid or accrued by the taxpayer to a foreign related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation).[177]

Base erosion payments generally do not include any amount that constitutes a reduction in gross receipts, including payments for cost of goods sold. Certain other payments are excluded from the definition of a base erosion payment, including certain payments for services[178] and any qualified derivative payment.[179]

Calculation of BEAT liability

BEAT liability generally equals the excess, if any, of 10 percent of the taxpayer's modified taxable income over the amount of regular tax liability[180] reduced (but not below zero) by the sum of a certain amount of Chapter 1 credits. The amount of regular tax liability is reduced (and the base erosion minimum tax amount increased) by all Chapter 1 credits except for the research credit[181] and a certain portion of applicable section 38 credits.[182] Modified taxable income is the taxpayer's regular taxable income increased by any base erosion tax benefit with

[176] Sec. 59A(d)(1).

[177] Sec. 59A(d)(2). A base erosion payment also includes any premium or other consideration paid or accrued by the taxpayer to a foreign related party for any reinsurance payments that are taken into account under section 803(a)(1)(B) or 832(b)(4)(A). Sec. 59A(d)(3).

[178] Sec. 59A(d)(5).

[179] Sec. 59A(h); see also Treas. Reg. sec. 1.59A-3(c)(6) (providing an election to waive certain deductions to reduce "allowed deductions" for purposes of determining base erosion tax benefit).

[180] As defined in section 26(b).

[181] Sec. 41(a).

[182] Sec. 59A(b)(4). Applicable section 38 credits are credits allowed under section 38 for the taxable year that are properly allocable to the low-income housing credit (sec. 42(a)), the renewable energy production credit (sec. 45(a)), and the energy investment credit (sec. 48). In general, no more than 80 percent of the amount of applicable section 38 credits for a taxable year can be used to reduce an applicable taxpayer's base erosion minimum tax liability and in no case can applicable section 38 credits reduce the taxpayer's base erosion minimum tax liability by more than 80 percent. Sec. 59A(b)(1)(B)(i)(II).

respect to any base erosion payment and an adjustment for the taxpayer's NOL deduction, if any.[183]

Special rules for taxable years beginning after December 31, 2025

For taxable years beginning after December 31, 2025, the 10-percent rate on modified taxable income is increased to 12.5 percent, and regular tax liability is reduced (and the base erosion minimum tax amount is therefore increased) by the sum of all the taxpayer's income tax credits for the taxable year.[184]

Special rules for banks and securities dealers

An applicable taxpayer that is a member of an affiliated group that includes a bank (as defined in section 581) or securities dealer registered under section 15(a) of the Securities Exchange Act of 1934 is subject to a tax rate on its modified taxable income that is one-percentage point higher than the generally applicable tax rate.[185] In addition, for purposes of determining whether they are subject to the BEAT, banks and securities dealers are subject to a base erosion percentage threshold of two percent (rather than three percent).[186]

4. Special rules

Foreign Investment in Real Property Act ("FIRPTA")

A foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") is treated as ECI.[187] Thus, a foreign person subject to tax on such a disposition is required to file a U.S. tax return. In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate). Certain sales of USRPI are exempt from this tax. For example, qualified foreign pension funds ("QFPF") are not treated as a nonresident alien individual or foreign corporation subject to tax under FIRPTA,[188] foreign governments are exempt from FIRPTA tax

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[183] An applicable taxpayer's modified taxable income is its taxable income for the taxable year increased by (1) any base erosion tax benefit with respect to any base erosion payment and (2) the base erosion percentage of any NOL deduction allowed under section 172 for such taxable year. Sec. 59A(c)(1).

[184] Sec. 59A(b)(2).

[185] Sec. 59A(b)(3).

[186] Sec. 59A(e)(1)(C).

[187] Sec. 897(a).

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

on gain from certain sales of stock of U.S. real property holding corporations,[189] and equity interests in "domestically controlled" REITs are not USRPIs.[190]

The payor of income that FIRPTA treats as ECI is generally required to withhold U.S. tax from the payment.[191] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's overall tax liability for the taxable year.

Branch profits taxes

A domestic corporation is subject to U.S. income tax on its net income. The earnings of the domestic corporation may be subject to a second tax, this time at the shareholder level, when dividends are paid. When the shareholders are foreign, the second-level tax may be collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to withholding tax. To approximate those second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign shareholders, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted (to the head office) out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation.[192] Those branch taxes may be reduced or eliminated under an applicable income tax treaty.[193]

Limitation on business interest

The amount of business interest (*i.e.*, any interest paid or accrued on indebtedness properly allocable to a trade or business) allowed as a deduction for any taxable year generally is limited to the sum of (1) business interest income of the taxpayer for the taxable year,[194] (2) 30 percent of adjusted taxable income of the taxpayer for the taxable year (not less than zero),

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

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

[191] Sec. 1445 and regulations thereunder.

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

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

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

[194] Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest income does not include investment income within the meaning of section 163(d). Sec. 163(j)(6).

and (3) the floor plan financing interest of the taxpayer for the taxable year.[195] Thus, other than floor plan financing interest, business interest expense in excess of business interest income generally is deductible only to the extent of 30 percent of adjusted taxable income. Stated differently, the rule operates to allow business interest up to the amount of business interest income. The deduction for any remaining business interest generally is limited to 30 percent of adjusted taxable income.[196] The amount of any business interest expense not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding year and may be carried forward indefinitely.[197]

The limitation on business interest generally applies to any taxpayer for any taxable year, subject to certain exceptions.[198] The limitation is applied at the taxpayer level, but special rules apply with respect to passthrough entities.[199] In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.[200]

Adjusted taxable income for purposes of section 163(j) generally means the taxable income of the taxpayer (A) computed without regard to (i) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (ii) any business interest or business interest income; (iii) the amount of any net operating loss deduction; (iv) the amount of any deduction allowed under section 199A; and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion; and (B) computed with such other adjustments as provided by the Secretary.[201] For taxable years beginning after December 31, 2021, adjusted taxable income for purposes of the section 163(j) limitation on business interest is computed with regard to any deduction for depreciation, amortization, or depletion.[202]

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[195] Sec. 163(j).

[196] For taxable years beginning in 2019 or 2020, the limitation was 50 percent. Sec. 163(j)(10)(A)(i). In addition, a taxpayer could elect to substitute its 2019 adjusted taxable income for its 2020 adjusted taxable income. Sec. 163(j)(10)(B). For a detailed description of section 163(j) and the special rules applicable to taxable years beginning in 2019 and 2020, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 116th Congress* (JCS-1-22), February 2022, pp. 335-340.

[197] Sec. 163(j)(2). Special rules for the carryforward of disallowed business interest expense apply only to partnerships and their partners. See sec. 163(j)(4)(B).

[198] Taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $29 million (for 2023) and certain regulated public utilities are not subject to this limitation. Sec. 163(j)(3) and (7)(A)(iv). Taxpayers in real property or farming trades or businesses (as defined in section 163(j)(7)(B) and (C)) may elect not to be subject to this limitation.

[199] See sec. 163(j)(4).

[200] See Treas. Reg. sec. 1.163(j)-4(d) (providing that a consolidated group has a single section 163(j) limitation and generally treating all members of the consolidated group as a single taxpayer for section 163(j) purposes).

[201] Sec. 163(j)(8).

[202] Sec. 163(j)(8)(v).

Sales of partnership interests

Gain or loss from the sale or exchange of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.[203] Any gain or loss from such hypothetical asset sale by the partnership must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

The transferee of a partnership interest must withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the sale qualifies for an exception from withholding, *e.g.*, that the transferor is not a nonresident alien individual or foreign corporation or that there is no realized gain from the sale.[204] If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.[205]

Hybrid arrangements

Hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve tax benefits, including double nontaxation and deferral. Special rules seek to combat the use of such arrangements. These rules include denying deductions relating to certain interest and royalty payments.[206] Specifically, no deduction is allowed for any "disqualified related party amount"[207] that is paid

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

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

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

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

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

or accrued pursuant to a hybrid transaction[208] or that is paid or accrued by, or to, a hybrid entity.[209]

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

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

II. OECD TWO-PILLAR SOLUTION

This section describes the current status of the OECD project undertaken at the direction of the G-20[210] to address base-erosion and profit shifting ("BEPS") concerns.[211] Although other actions taken in the BEPS project have been adopted by various jurisdictions, including the United States,[212] the OECD final report on how to address problems presented by the digital economy did not provide proposed standards or solutions.[213] Since then, many jurisdictions have taken unilateral action to target certain aspects of digital services provided in general by large technology companies headquartered in the United States, including by imposing unilateral digital services taxes ("DSTs"). At the urging of the G-20, the OECD continues to work on the project, has proposed blueprints of two pillars as a solution,[214] and has held public consultations for further development of those pillars.

In October 2021, the OECD and the G-20 announced that the Inclusive Framework had agreed in principle to the proposed two-pillar solution to address the tax challenges arising from the current state of international taxation of multinational enterprises ("MNEs").[215] The Statement included a moratorium on adoption or enforcement of unilateral measures. The signatories agreed that "[n]o newly enacted Digital Services Taxes or other relevant similar

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

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

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

[213] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, October 5, 2015, available at http://www keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report 9789264241046-en. The concern is that foreign multinational companies without a physical presence in a jurisdiction could impact the local economy, earning revenues generated by the digital activity within their jurisdiction, without incurring taxation under existing international norms of taxation.

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

[215] OECD (2021), *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* ("Statement"), OECD, Paris, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm.

measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the [Multilateral Convention]."[216]

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

On July 11, 2023, the OECD and the G-20 released an outcome statement (approved by 138 member countries) on the two-pillar solution, outlining the progress made to date and extending the moratorium on new DSTs through the earlier of December 31, 2024, or the entry into force of the Multilateral Convention.[217]

A. Pillar One

Under the terms of the Pillar One Blueprint, as well as all subsequent iterations of the terms of Pillar One, members of the Inclusive Framework agree to rescind existing, and forgo future, DSTs and other unilateral measures in return for international consensus regarding the proper allocation of taxing rights with respect to certain profits of multinational enterprises. Such allocation would include ceding taxing rights to market jurisdictions, within a framework that ensures tax certainty for the affected firms within scope of the measure. Since initial publication of the Pillar One Blueprint, the specific components of the proposal have changed with each iteration of the components in documents published by the OECD Secretariat. As of July 11, 2023, no consensus document exists. Instead, technical work toward an agreed upon set of model rules and commentary continues. Ultimately, such rules and commentary will serve as the basis for a multilateral instrument to be signed by members for implementation.[218]

The following aspects of Pillar One are addressed below, based on the most recent publications as of July 11, 2023: the scope and required nexus, the determination of the residual profit that is allocated to market jurisdictions ("Amount A"), including a proposed marketing and distribution profits safe harbor ("MDSH");[219] the allowance for a fixed routine return reportable

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[216] *Ibid.*, p. 3.

[217] See https://www.oecd.org/tax/beps/outcome-statement-on-the-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2023.pdf.

[218] OECD (2023) *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, India, February 2023*, OECD, Paris, https://www.oecd.org/g20/topics/international-taxation/oecd-secretary-general-tax-report-g20-finance-ministers-india-february-2023.pdf.

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

to market jurisdictions ("Amount B");[220] and the administrative framework to ensure tax certainty by preventing disputes and requiring arbitration in certain cases.[221]

<u>Scope and nexus</u>

To determine whether a taxpayer is within scope of Pillar One (*i.e.*, a "covered entity"), both revenue thresholds and the nature of activities are considered. A covered entity is defined as an entity in a multinational group, or a covered group, where the revenues of the group for the relevant period are greater than €20 billion, and the pre-tax profit margin of the group is greater than 10 percent. Revenues and profits from qualifying extractives and regulated financial services are excluded.[222] In addition, in certain cases, a particular line of business or segment may be treated as a standalone entity that is within scope as a disclosed segment. Although the impetus of the project is concern about the digitalization of the economy, the United States has successfully argued that the digital industry cannot and should not be ring-fenced: that is, the resolution should not define a specific subset of companies that are to be treated differently from all other residents in any of the countries within the Inclusive Framework, noting both the continuing trend toward digitalization of all industries, as well as the risk that any such ring-fencing would disproportionately affect U.S. companies.

Together, the revenue thresholds and activity tests are intended to help identify the markets in which the end user is located, both by applying revenue sourcing rules that will vary with the type of service or good as well as particular market revenue thresholds. Revenues are treated as arising in a jurisdiction, or sourced to a jurisdiction, depending on the type of revenue. For example, revenues sourced from location-specific services are sourced to the place of performance of the service. Revenues sourced from online advertising services are sourced to the location of the viewer of the advertisement.[223]

A covered entity or group has nexus with a jurisdiction for the relevant taxable period if its revenues arising in the jurisdiction are equal to or greater than €1 million. However, if the jurisdiction's GDP is less than €40 billion, nexus is satisfied if the covered group's revenues in the jurisdiction are equal to or greater than €250,000.

The expectation is that the thresholds will be based on consolidated financial statements of a multinational group prepared using acceptable financial accounting standards such as

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

[221] OECD (2022) *Progress Report on the Administration and Tax Certainty Aspects of Amount A of Pillar One* ("*Tax Certainty Progress Report*"), OECD Paris https://www.oecd.org/tax/beps/progress-report-on-the-administration-and-tax-certaint-aspects-of-amount-a-of-pillar-one-two-pillar-solution-to-the-tax-challenges-of-the-digitalisation-of-the-economy.htm.

[222] *July Progress Report,* pp. 10-12, and Schedules B and C, pp. 32-58.

[223] *July Progress Report*, pp. 14-15.

Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS").[224]

Amount A: Allocation of the new taxing right

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

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

The formula for this determination is as follows:

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

$Profits = Revenues - Deductions,$

where –

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

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

Revenues is the covered group revenues,

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

Deductions is the covered groups allowable deductions excluding taxes, and

Local/Revenues is the allocation key that represents the ratio of revenues arising in that jurisdiction (or "*Local*") to the revenues of the whole group (or "*Revenues*"). [225]

Safe harbor for marketing and distribution

After determining the portion of profits that may be eligible to reallocate to a jurisdiction, the MDSH may also be available for certain covered groups. If the MDSH applies, then all or a portion of the amount eligible for allocation under Amount A is reduced. This adjustment downwards in the profits allocated to the jurisdiction is intended to relieve double taxation that may result if a jurisdiction has already been allocated profits under existing transfer pricing rules. Although the safe harbor has been discussed in terms of marketing and distribution, its calculation is prescribed in terms of determining a fixed rate of return on depreciation and payroll ("RODP") to establish a cap on allocable residual profits more generally (looking at

[224] *July Progress Report*, p. 24; *Pillar One Blueprint*, p. 101.

[225] *July Progress Report*, p. 15-17.

"nonroutine returns" within the jurisdiction) and permits a fixed offset percentage of those returns to be used to offset Amount A. If adequate returns for routine in-country RODP are already reported in a jurisdiction, or if the returns already reported in a jurisdiction exceed the amount eligible for allocation under Amount A, then no allocation is to be made to that jurisdiction. The applicable offset percentage is not yet stipulated.

This MDSH adjustment is subject to further deliberation at the OECD, with a focus on addressing concerns that a pure RODP approach could result in inappropriate outcomes for routine activities with a low payroll and asset base.[226]

Allocation of elimination profits

The obligation to eliminate double taxation with respect to Amount A is also allocated among those jurisdictions identified as a relieving jurisdiction for a covered group. First, there is a calculation of the elimination profit,[227] which is a sum of financial accounting profit or loss in a jurisdiction, adjusted for various items, similar to the concept of Global Anti-Base Erosion income ("Globe income") in Pillar Two (discussed below). Second, there is an identification of jurisdictions for which the elimination profit equals at least 95 percent of the group's total profit. Third, the jurisdictions are grouped into four tiers, depending on profitability as measured by reference to RODP in the jurisdiction relative to the overall profitability of the group.[228] Finally, the obligation to eliminate double taxation is allocated to the jurisdictions with the highest RODP and iteratively to the next highest RODP until the obligation to eliminate double taxation has been fully allocated.[229]

If there are multiple Tier 1 jurisdictions (*i.e.*, jurisdictions in which the RODP in that jurisdiction is greater than 1500 percent of the RODP of the group), the jurisdiction with the highest RODP eliminates double taxation through a reduction of taxable profits until that jurisdiction's RODP is equal to the RODP of the second jurisdiction. Once the first jurisdiction has the same RODP as the second jurisdiction, the jurisdictions jointly reduce their RODP until they are at the level of the third jurisdiction, which then also reduces its RODP. If double taxation is not fully relieved from Tier 1 profits, Tier 2 jurisdictions (*i.e.*, jurisdictions in which the adjusted RODP in that jurisdiction is greater than 150 percent of the RODP of the group) are required to relieve double taxation according to the same waterfall. If double taxation is not fully relieved from Tier 1 and Tier 2 jurisdictions, the same then applies to Tiers 3A (*i.e.*, jurisdictions in which the adjusted RODP in that jurisdiction is greater than 40 percent of the RODP of the group) and Tier 3B (*i.e.*, jurisdictions in which the adjusted RODP in that jurisdiction is greater than greater than the elimination threshold RODP of the group).[230]

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[226] *July Progress Report*, p. 17, fn. 3.

[227] *July Progress Report*, Schedule I, pp. 86-94.

[228] *July Progress Report*, p. 20, par. 5.

[229] *July Progress Report,* pp. 20-22 and Schedule J, p. 93-94.

[230] *July Progress Report*, Schedule J, p. 93-94.

Amount B

Sensitivity to the fact that routine transactions are frequent sources of transfer pricing disputes, and that many jurisdictions have limited capacity to handle such disputes, prompted an effort to identify a subset of transactions for which a streamlined approach to intercompany pricing is appropriate, as well as a streamlined pricing methodology and a basis for identifying an arm's-length result where comparable transactions may be unavailable.[231] Amount B is intended to be limited in scope to those transactions that can be reliably evaluated under a streamlined qualitative analysis and a streamlined pricing methodology, the outcomes of which provides results that are consistent with existing transfer-pricing norms.

By limiting Amount B to controlled transactions that involve routine distribution or marketing activities within the distributor or marketer's jurisdiction of residence, for which the distributor does not undertake significant risk, potential exemptions may be appropriate, and the otherwise required necessary analysis of functions may be streamlined. In developing the criteria for determining what transactions should be considered within scope of Amount B, a nonexclusive list of disqualifying activities, such as research and development, manufacturing, financing, or procurement, are under consideration. If an existing advanced pricing agreement covers the transaction for the group, such transaction is excluded from the scope of Amount B.

In addition, the routine nature of the in-scope transactions may allow for streamlined pricing methodology, possibly as a variation of a transactional net margin method. Whether such a streamlined methodology is mandatory or elective remains under consideration, as are questions such as to whether the availability of comparable transactions in the local market should be determinative of the pricing methodology permitted. In particular, whether the use of the Amount B methodology is required even if another method may be determined to be the most appropriate method remains an open issue. Work continues with respect to the development of both common benchmarking search criteria and a global dataset.[232]

As of July 11, 2023, an implementation framework has not yet been designed for this aspect of Pillar One and could ultimately take the form of either an elective safe harbor or a prescribed standard for determining baseline or distribution activities. The principles to be considered in the development of such framework include the flexibility of existing transfer pricing guidelines requiring a balance of reliability of the methods chosen as well as administrability.

Tax certainty

The need for improved administrative procedures that both prevent disputes as well as offer robust dispute resolutions methods has been a feature of Pillar One since the Blueprint was published in 2020. The scope and type of measures, however, have changed over time.

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[231] *Amount B Report.*

[232] *Amount B Report*, p. 30.

Tax certainty for Amount A

In late 2022, the OECD described a framework for achieving tax certainty for Amount A as well as issues related to Amount A. With respect to the latter, there is little agreement about what constitutes an issue related to Amount A. In addition to the dispute prevention effect of broad consensus on proper use of specified percentages and formulas to compute Amount A, an administrative framework that includes uniform standards for documentation, currency conversion rules, and filing requirements may minimize disputes. Different measures of certainty may be provided at different stages of the process of determining Amount A. For example, early confirmation of whether an entity is within scope of Pillar One is expected.[233]

Details regarding the processes anticipated for dispute resolution with respect to Amount A is expected to include mandatory arbitration of the type included in several of the most recent U.S. tax treaties.[234] The extent to which the scope of such arbitration will include related or correlative adjustments that arise as a result of reallocation is uncertain, but under consideration, due to the nature of the new taxing rights as an overlay on traditional transfer pricing rules. The scope of mandatory arbitration expected to be included in a multilateral instrument may need to accommodate existing treaty networks of member jurisdictions, though it is expected to establish a minimum standard. In addition, safe harbors for advanced pricing agreements in place are anticipated, with the expectation that future such agreements would be in conformity with Pillar One principles.

Tax Certainty for Amount B

In contrast to Amount A, as of July 11, 2023, no specific administrative procedures for assuring certainty with respect to Amount B have been proposed, though the general mutual agreement procedures of treaty networks are expected to remain relevant to future disputes. Instead, certainty is expected by incorporation of Amount B principles into transfer pricing guidelines. More importantly, if the methodologies of Amount B are implemented, it is expected that the range of issues or disputes that would arise are expected to be significantly truncated by the streamlined methodologies applicable to Amount B. Because the need for Amount B arose as a result of concern about the number of resource-intensive disputes in jurisdictions that may lack the resources to process such cases efficiently,[235] additional administrative measures may be needed to streamline not only the computational methodology but also the administrative review.

DSTs and other unilateral measures

As explained above, the revocation or removal of the unilateral DSTs enacted in several jurisdictions in response to the BEPS project's failure to address concerns arising from

[233] *Tax Certainty Progress Report,* p. 63 and related flowchart.

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

[235] *Amount B Report,* pp. 28-29, par. 43.

digitalization of the economy was a condition to the agreement that resulted in the new taxing right created under Pillar One. The terms proposed for a multilateral instrument to preclude such unilateral measures include a definition of DSTs and similar measures that are unacceptable, prohibited measures under Pillar One.[236] Such taxes generally are not income taxes, but instead are taxes imposed on market-based criteria in a manner that either explicitly or in practice applies only to foreign and foreign-owned businesses. Value-added taxes, transaction taxes, and anti-abuse measures are generally not within the scope of the prohibited measures. Article 37 requires that all members rescind DSTs and similar measures; Article 38 would proscribe allocation of residual profits under Amount A to jurisdictions in violation of Article 37. An administrative process to review whether a levy or tax is in violation of Article 37 is expected. For a list of existing provisions that have been adopted in various jurisdictions that would be expected to be rescinded under the terms of Pillar One, see Appendix A.

[236] OECD (December 2022) *Pillar One—Amount A: Draft Multilateral Convention Provisions on Digital Services Taxes and Other Relevant Similar Measures,* https://www.oecd.org/tax/beps/public-consultation-document-draft-mlc-provisions-on-dsts-and-other-relevant-similar-measures.pdf.

B. Pillar Two

In December 2021, the OECD published "Global Anti-Base Erosion Model Rules (Pillar Two)," which provides for a system of taxation based on financial accounts applying a minimum rate of 15 percent on a jurisdictional (country-by-country) basis (the "Model Rules").[237] In March 2022, the OECD published general commentary (and related examples) on the Model Rules,[238] and in December 2022, the OECD published guidance on a transitional safe harbor, a framework for a permanent safe harbor, and transitional penalty relief.[239] In February 2023, the OECD published administrative guidance on the Model Rules to address certain specific questions in need of clarification and simplification.[240] A number of jurisdictions have agreed in principle to adopt Pillar Two, and some have already enacted legislation or proposed legislation to adopt at least some aspects of the Model Rules. See Appendix B.

The Model Rules[241]

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

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

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

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

[240] OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two),* OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two.pdf.

[241] The following is a high-level summary of the Model Rules and related guidance as of July 11, 2023.

Companies in scope

The Model Rules apply to MNE groups (and their constituent entities) that have annual revenue of €750 million or more in the consolidated financial statements of the ultimate parent entity in at least two of the four fiscal years immediately preceding the tested fiscal year.[242] An MNE group (or here just MNE) means a collection of entities that are related through ownership or control such that the assets, liabilities, income, expenses, and cash flows of those entities are included in the consolidated financial statements of the ultimate parent entity with at least one entity (or permanent establishment) that is not located in the jurisdiction of the ultimate parent entity.[243] The ultimate parent entity generally is one that owns (directly or indirectly) a controlling interest in any other entity and in which no other entity owns a controlling interest.[244]

Application of the top-up tax

Top-up tax is due with respect to income in a jurisdiction if book income ("Globe income," discussed below) in the jurisdiction is subject to an effective tax rate ("ETR") of less than 15 percent. The additional top-up tax may be collected first by the source country,[245] second by the residence country of the MNE's ultimate parent entity,[246] third by the residence country of a lower-tier parent entity,[247] and finally by the residence country of any other affiliated entity.[248]

Globe income and the base of the top-up tax

Globe income (or loss) in a country generally is the net income (or loss) determined for an entity in preparing consolidated financial statements of the ultimate parent entity.[249] If Globe income in a country is subject to an ETR of less than 15 percent, then the Globe income is subject to a top-up tax.

The ETR for a jurisdiction is equal to the sum of the "adjusted covered taxes" paid in that jurisdiction divided by the net Globe income in that jurisdiction.[250] Adjusted covered taxes are the current tax expenses that have accrued for purposes of calculating that year's financial

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[242] Art. 1.1.1 of the Model Rules.

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

[244] Art. 1.4.1 of the Model Rules.

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

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

[247] Also under an IIR.

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

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

[250] Art. 5.1.1 of the Model Rules.

accounting net income, adjusted for certain deferred tax assets and deferred tax expenses, as well as other differences between tax reporting and financial reporting.[251]

The base of the top-up tax ("excess profit") generally is Globe income[252] less the substance-based income exclusion for the country.[253] The substance-based income exclusion is five percent of (1) eligible payroll costs in the country and (2) the carrying value of eligible tangible assets in the country.[254] Thus, for companies that have payroll costs and eligible tangible assets in the relevant country, the amount of the top-up tax always is less than the amount of additional tax necessary to increase the ETR on Globe income to 15 percent.

In other words:

Top-up tax = (15% – ETR) x (net Globe income – substance-based income exclusion)[255]

Ordering of the top-up tax

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

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

A natural question arises: why would country X choose to apply a new tax (the QDMTT) instead of simply changing its local corporate tax, whether by increasing the rate (to 15 percent) or expanding the base (to resemble Globe income more closely)? The answer is that the tax base for purposes of determining an MNE's ETR is generally greater than the tax base for purposes of determining the top-up tax. A 15-percent corporate tax that followed the Model Rules in determining its tax base would tend to collect more corporate tax than required under the top-up tax.[256] In other words, the QDMTT represents the only way under Pillar Two for a country to collect in every case the minimum tax liability due with respect to Globe income arising in its jurisdiction.

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[251] Art. 4.1 of the Model Rules.

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

[253] Art. 5.2.3 of the Model Rules.

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

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

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

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

Income inclusion rule ("IIR")

The secondary right to collect a top-up tax with respect to Globe income earned in a source country is with the jurisdiction of the MNE's ultimate parent entity.[257] This top-up tax is known as the IIR. The mechanism is like other tax regimes ("CFC taxes") that require an ultimate parent entity to pay current tax on the income of controlled foreign corporations ("CFCs"), including Subpart F income and GILTI under U.S. law.[258] In terms of ordering, QDMTTs come before CFC taxes, and CFC taxes come before IIRs (which all come before UTPR, as discussed below).

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

Undertaxed profits rule ("UTPR")

The final mechanism providing for the collection of top-up tax is the UTPR. If a top-up tax is due, but the source country does not impose a QDMTT and no parent entity is in a jurisdiction imposing an IIR, then countries in which other MNE affiliates are located may collect the top-up tax under a UTPR. Those countries share the top-up tax according to the number of employees in each UTPR jurisdiction and the value of tangible assets in each UTPR jurisdiction.[259]

Tax credits, grants, and the ETR

The ETR on Globe income in a source country may depend on the treatment of certain incentives provided by the country. Grants are treated as additions to Globe income; tax credits are treated as reductions to taxes paid for purposes of calculating the ETR. Certain refundable

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

[258] See generally Part I of this document.

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

tax credits (*i.e.*, "qualified refundable tax credits" or "QRTCs"), however, are treated as grants and, therefore, increase Globe income rather than reduce taxes paid.[260]

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

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

III. ECONOMIC ANALYSIS

A. Economic Considerations Related to Pillar One and Pillar Two

1. Background

In October 2021, the OECD announced that more than 140 members of the OECD/G-20 Inclusive Framework on Base Erosion and Profit Shifting agreed to the implementation of a Two-Pillar international tax proposal.[261] As noted in Part II.A., Pillar One of this proposal would in part revise the principles governing profit allocation and the extent and nature of nexus that is deemed sufficient to allow a country (the "market jurisdiction") to tax some portion of an MNE's income (*i.e.,* Amount A), as well as propose a simplified method of applying arms' length principles based on guidance provided in OECD transfer pricing guidelines (*i.e.*, Amount B). Pillar Two of this proposal introduces new rules to ensure a minimum level of effective taxation that member countries are encouraged to adopt in their domestic law. At present, while some member states have enacted laws to become compliant with Pillar Two, none of the laws are yet in effect.[262] As neither Pillar One nor Pillar Two has been implemented, and as some (but not all) important details related to their design were agreed upon only in 2021, studies analyzing the economic effects of these provisions are limited. Therefore, this section largely focuses on the design of the Pillars and on qualitative discussions of the implications of full and partial implementation.

2. Pillar One

<u>Implementation of Pillar One</u>

<u>Destination-based income taxation</u>

At this time, important aspects of the mechanics of Pillar One have yet to be resolved. However, economists have analyzed systems of taxing cross-border income that share the key attribute of Pillar One: the allocation of taxing rights onto market jurisdictions (often referred to as a destination-based approach). Three prominent destination-based tax systems have been studied: (1) a destination-based cash flow tax, (2) sales-based formulary apportionment, and (3) residual profit allocation.[263] Because the location of production is likely more mobile than the location of the final consumer, destination-based tax systems may be more efficient than traditional, origin-based systems. In addition, these systems may limit or eliminate the incentive to shift profits relative to present tax systems. However, each of these systems also introduces new (and potentially more difficult) administrative challenges, and even though the location of

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

[262] See Appendix B for a list of Pillar Two enacting countries.

[263] For a more general discussion of the economic features and effects of destination-based approaches to taxing cross border income, see Joint Committee on Taxation, *Destination-Based Taxation and Border Adjustments* (JCX 20-17), May 22, 2017.

the final consumer may be immobile, the location of sales—which is ultimately the observable measure upon which taxes would be based—may be more manipulable, depending on how defined.[264]

Destination-based cash flow tax[265]

From a cross-border tax perspective, the key feature of a destination-based cash flow tax is that, for a specific country, the tax base consists of proceeds[266] from the sale of goods and services to purchasers located in that country, regardless of where the goods and services were produced. In particular, proceeds derived from exports are exempt while proceeds from imports are taxable, allowing market jurisdictions full taxing rights to proceeds derived from sales to that jurisdiction.

As mentioned above, relative to an origin-based tax, a destination-based cash flow tax limits profit shifting from the home country because the home-country tax on proceeds from sales to foreign jurisdictions is zero, so there is no incentive to locate proceeds in a tax haven (or any other country with a tax rate lower than that home country).[267] Because profit shifting incentives are minimized, so are incentives to locate investment or employment in low-tax jurisdictions for the sole reason of substantiating the allocation of more proceeds to those low-tax jurisdiction.

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

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

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

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

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

Sales-based formulary apportionment[268]

Under sales-based formulary apportionment, taxing rights to an MNE's global profits are allocated based on the proportion of its global sales to a particular market jurisdiction. Similar to other destination-based taxes, income shifting and distortions to the location of economic activity are minimized to the extent that the location of sales is not easily manipulated. Sales-based formulary apportionment is viewed by some economists as a relatively simple and transparent system that appears fair in the sense that taxation is based on economic activity (including sales) in a jurisdiction.[269] However, some economists contend that sales-based formulary apportionment may distribute the tax base in a relatively arbitrary manner that may not bear relation to where income is earned, thus resulting in inefficient incentives for firms and governments. In addition, MNEs would be encouraged to locate more sales in low- or zero-tax jurisdictions and fewer sales to higher-tax jurisdictions to which a sale is attributed.[270] The same critique (manipulation of the location of sales) applies if sales-based formulary apportionment were to be adopted unilaterally. Profits recognized as taxable by a host country may not match profits allocated to that host country based on sales. This misalignment would generally result in administrative challenges as well as double taxation.

Pillar One shares similarities with sales-based formulary apportionment, except that (1) taxing rights to only a portion of global profits are assigned on the basis of sales and (2) the formula for assigning taxing rights to that portion is more complicated and not 100 percent directly proportional to sales. In particular, Pillar One would be close to sales-based formulary apportionment if (1) it applied to all MNEs and (2) Amount A were 100 percent of Adjusted Profit Before Tax, instead of calculated as adjusted profit before tax, decreased by 10 percent of revenues of the MNE. One paper comparing a form of sales-based formulary apportionment with Pillar One argues that Pillar One is even more distortionary to the extent that it would apply to a small number of large companies, and only to a subset of their profits.[271]

Residual profit allocation

Residual profit allocation resembles formulary apportionment to the extent that taxation of global profits is allocated on the basis of sales. In contrast to sales-based formulary

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[268] For an example of a sales-based formulary apportionment system, see Reveun S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits: A Proposal to Adopt a Formulary Profit Split," *Florida Tax Review*, vol. 9, no. 5, 2009, pp. 497-533. For more general discussions of the strengths and weaknesses of sales-based formulary apportionment, see Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön, and John Vella, "Taxing Profits in a Global Economy," *Oxford: Oxford University Press*, 2021, pp. 139-150; and Harry Grubert, "Destination-Based Income Taxes: A Mismatch Made in Heaven," *Tax Law Review*, vol. 69, no. 1, Fall 2015, pp. 43-72.

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

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

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

apportionment, a routine return is allowed. In general, a residual profit allocation involves (1) an allocation of taxing rights on an MNE's profits representing a "routine" return (*i.e.*, normal return calculated by some arm's length pricing method) on activities and functions performed in particular jurisdictions to those jurisdictions, and (2) a destination-based allocation of taxing rights on an MNE's remaining "residual" profit—the excess of its aggregate profits over its total routine earnings (*i.e.*, the rent or supernormal profit of a multinational) across jurisdictions using a sales-based formula. The analyses of residual profit allocations may help provide a general understanding of the economic effects of Pillar One.

One paper explores the implications, conceptual and empirical, of countries moving to some form of residual profit allocation approach.[272] There are three primary findings: (1) the effect on tax revenue appears beneficial for developing countries because of the relatively greater revenue loss that developing countries currently suffer from profit shifting and the gain from the reallocation of MNEs' excess profits to developing countries based on sales to those countries; (2) incentives to invest in all countries are reduced to the extent that the residual profit allocation approach eliminates profit shifting; and (3) global production efficiency may increase, especially if routine profits are minimally taxed, as destination-based taxation generally leads to fewer distortions in the location of investment as well as MNE ownership decisions.[273]

Economic effects of Pillar One

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

Pillar One may also raise concerns related to tax sovereignty. Pillar One proposes a novel, panel-based, mandatory, binding dispute-prevention process to provide tax certainty, which is a process that includes identifying which countries are to make the necessary adjustments. Some countries may view this as a threat to their sovereignty, which may make them less likely to support Pillar One.[274]

In general, Pillar One provides a comprehensive approach to dealing with double taxation, but the approach is complex and adds administrative costs. To avoid double taxation, the proposal aims to offset a tax increase in the market jurisdiction with an offsetting adjustment to taxable income elsewhere (*i.e.*, to another element of the business that may possibly be in

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

[273] *Ibid*.

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

another jurisdiction). A question then arises as to which elements of the business are likely to see a reduction in their taxable profit to offset the additional profit allocated to the market jurisdiction. If at least a routine rate of return is allocated to each separate entity within the MNE, transfer prices may need to be adjusted in such a way that the reduction in taxable profit must occur in entities to which the residual profit is currently allocated. In this case, the manipulation of transfer prices adds a potential undesirable layer of complexity and administrative costs. This in turn may redirect resources (*e.g.,* labor hours) towards additional tax planning instead of economic or business activity. One article argues for an alternative approach to the Pillar One proposal whereby the new elements of tax introduced should not be creditable against other taxes in order to simplify its implementation.[275] However, this could lead to double taxation.

Another potential concern with Pillar One is the extent to which overall tax liability may increase as a result of additional market jurisdiction tax and how that potential increase in tax liability may affect future investment decisions. While a tax that falls only on economic rent should be non-distortionary, residual profit, as defined in Pillar One (generally, adjusted profit before tax decreased by 10 percent of revenues), is not economic rent. According to standard economic theory, firms will invest in projects only if they are expected to meet a required return on investment (*i.e..,* normal return). Imposing or increasing a tax on the normal return will reduce investment because fewer projects will yield the required return necessary to make an investment attractive. However, a tax on the amount that is in excess of a normal return (*i.e.,* super-normal returns or economic rent) will not reduce investment. By definition, as long as firms make their required return on investment, any tax on economic rent will not prevent the business from meeting its required return, unless the tax rate on economic rent exceeds 100 percent, in which case some tax burden falls on the required return and therefore leads to less investment. To the extent that distortions in investment decisions increase with the effective tax rate on returns to those investments,[276] the potential increase in tax resulting from Pillar One could lead to distortions and economic inefficiency.

Methods proposed in Pillar One to determine that amount of residual profit to be taxed by the market jurisdiction are not the same as the methods used to determine where the residual profit is currently taxed. Pillar One is intended to work on the principle that credit should be given against identified residual profit.[277] The rationale behind this approach seems to be that, since the tax base in the market jurisdiction is measured as a fraction of the residual profit, the country receiving the credit should be the country where that residual profit is currently taxed. This rationale for the Pillar One proposal depends on the notion that the income that is reallocated to the market country actually reflects the residual profit. Perhaps, though, taking a fraction of residual profit as reflected in the consolidated group accounts is simply a convenient mechanism for implementing the reallocation of some taxing rights to the market country.

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[275] *Ibid.*

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

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

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

Pillar One as currently contemplated is relatively narrow in its application, taxing only MNEs with global revenue exceeding €20 billion and profit margins exceeding 10 percent, with exceptions for financial services and extractives industries. Rules for determining the scope of Pillar One involve trade-offs. On the one hand, restricting the scope of the proposal in any fashion may require policing the boundary between activities that are in scope and out of scope for the purposes of the tax, resulting in possible tax planning around this boundary. On the other hand, broadening the scope requires a wider set of revenue-sourcing rules, which comes with considerable design, implementation, and administration challenges and would increase aggregate compliance and administrative costs for governments and businesses. One article argues that due to its complexity and administrative cost, Pillar One can reasonably be applied only to a relatively small number of businesses, implying the need to restrict its scope by sector or business size, or both.[278]

As mentioned above, Pillar One only applies to certain MNEs that satisfy certain revenue and profitability thresholds. There is a sharp discontinuity produced by this threshold that determines whether a firm is in scope. Firms just slightly below the size threshold have none of their profits apportioned to Amount A, whereas firms just slightly above have all their residual profits so apportioned. One paper argues that firms can control their own aggregate revenues with mergers, acquisitions, and divestments. As a result, firms just below the Pillar One threshold may distort their behavior to stay below the threshold by not increasing asset ownership and revenue; while firms above the Pillar One threshold may distort their ownership to get below the threshold.[279] Both of these distortive behaviors may reduce firms' productive efficiency.

There may be inefficient incentives for taxpayers and governments that are intrinsic to the sales-based Amount A apportionment method. One paper argues the disconnect between taxing rights assigned by Amount A and taxing rights corresponding to where productive assets are located generates additional distortions even for in-scope firms that expect to remain in scope.[280] Also, highly profitable firms have the incentive to divest any business operations that produce sales in high-tax countries. Then for any given production structure, in-scope firms have the incentive to concentrate their sales on customers in low-tax countries, leaving other firms to serve customers in high-tax countries. The subset of in-scope firms may have the option

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[278] *Ibid*.

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

[280] *Ibid*.

to realign their business operations with their counterparties, because all other firms, including most large firms, are not subject to taxation by the Amount A.

Lastly, Pillar One may limit tax avoidance by allocating taxable profit away from entities with little or no economic substance, typically located in tax havens.[281] For example, consider an MNE that has a parent entity in country A and R&D and manufacturing activities in country B, and that holds its intellectual property in tax haven C. Residual profits are located in countries A and C, but not B. Suppose that the profit located in tax haven C represents the result of profit shifting from the other countries. In that case, if Pillar One results in taxable profits being taxed in jurisdictions other than tax haven C, one may argue that the system is less prone to profit shifting. However, given that certain factors of the mechanics of Pillar One have yet to be determined, there could still remain both incentives and opportunities for MNEs to avoid taxes by adjusting their operations and ownership of productive assets.

3. Pillar Two

Implementation of Pillar Two

In comparison to Pillar One, the mechanics of Pillar Two are more developed. When investigating the incentives for countries to implement and maintain the global minimum tax introduced by Pillar Two, some economists have compared it to a different scenario where firms form a collusive agreement, a cartel, on price and sales to third parties, which removes competition between them and permits them to earn higher profit both individually and collectively.[282] In the context of a global minimum tax, coordinating on a minimum tax removes some amount of tax competition between jurisdictions when they agree to charge a minimum tax rate to achieve higher tax revenues.

In theory, one concern with a collusive agreement among firms on prices and sales is that there may be an incentive for each firm (*i.e.,* government in the case of Pillar Two) to retract on the agreement by undercutting its rivals. In the case of a business cartel, the retracted firm may earn higher profit in the short run because that firm may dominate the market. Dependent on the reactions of the rival firms, that advantage may not survive in the long run. For example, if the entire agreement falls apart as a result, then all the firms would earn lower profits in the long run. To prevent any firm from retracting on the agreement, there must be a credible threat by the other firms that they would take action that would make the retracted firm worse off in the long run. To be credible, the remaining firms must also not be worse off by carrying out the threatened action compared with not doing so.

In regard to Pillar Two, a mechanism that effectively creates such a credible threat is that other countries in which the MNE operates may collect the tax that is underpaid in any particular country, such as through the undertaxed profits rule ("UTPR"). A key element is that if the country of the parent entity does not introduce the income inclusion rule ("IIR") (*i.e.,* where the

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[281] *Ibid.*

[282] Michael P. Devereux, "International Tax Competition and Coordination with a Global Minimum Tax," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 145-166.

parent entity jurisdiction has the priority to apply the top-up tax to all of its subsidiaries) on the worldwide income of the MNE, then other countries in which the MNE has a presence may collect the same revenue through denying deductions to any subsidiaries of that parent's MNEs resident in their countries (subject to limitations and rules on how the total is allocated). In general, unilateral implementation of such a tax runs the risk that parent entities will seek to move, or set up, in a country that does not implement such a tax. That risk varies among countries, depending on their size, structure and strength of their economy, and capacity to create legal obstacles to entities shifting their place of residence.

One descriptive paper argues that Pillar Two has sufficient elements to create incentives for large headquarters countries (*e.g.,* G7 countries[283]) to implement it, and then conditional on them doing so, there is an incentive for host countries (*i.e.,* the country with the foreign affiliate of the MNE with headquarters in a G7 country) to follow suit.[284] For example, if the United States unilaterally introduced a UTPR, then it would prove less costly for other G7 countries to adopt an IIR in terms of the incentives for parent entities to avoid locating in those countries. The incentive to introduce an IIR becomes stronger the more countries introduce the IIR and UTPR. Thus, while the precise calculations facing each individual country are uncertain, it seems plausible that joining the coordinated Pillar Two agreement on the IIR and UTPR would prove advantageous to G7 countries, and then hence also to other countries. In support of this argument, one paper presents descriptive evidence from the Orbis database[285] that because most in-scope MNEs operate in several large, developed countries (*e.g.,* G7 countries), a coordinated implementation of the global minimum tax in a critical mass of even three or four such countries would create a significant incentive for other such countries to follow suit in implementing the global minimum tax.[286]

Lastly, Pillar Two includes the qualified domestic minimum top-up tax ("QDMTT"), where the host jurisdiction has the priority to apply a domestic minimum tax to collect any top-up tax on their domestic corporations. The QDMTT would give implementing countries an incentive to set the corporation's tax liabilities of in-scope MNEs to at least the minimum.[287]

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[283] The G7 countries include Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

[284] Michael P. Devereux, "International Tax Competition and Coordination with a Global Minimum Tax," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 145-166.

[285] The Orbis database contains comparable information on around 400 million private companies from all countries.

[286] Michael P. Devereux, Johanna Paraknewitz, and Martin Simmler, "Empirical Evidence on the Global Minimum Tax: What Is a Critical Mass and How Large Is the Substance-Based Income Exclusion?," *Fiscal Studies*, vol. 44, no. 1, March 2023, pp. 9-21.

For the percentage of entities that may be affected by the Pillar Two compliant jurisdictions, if those jurisdictions were to implement Pillar Two, see Table 8 in Section IV. Overall, if the Pillar Two compliant jurisdictions were to implement a UTPR, the Joint Committee staff estimates that 98.9 percent of entities may be affected.

[287] Michael P. Devereux, "International Tax Competition and Coordination with a Global Minimum Tax," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 145-166.

Setting the tax liability below this would not attract inward flows of investment or profit, because any tax uncollected below this minimum would instead be collected by another country through an IIR or UTPR. There would therefore be a clear incentive for the host country of the foreign affiliate to collect the tax revenue, rather than see it collected elsewhere.

Economic effects of Pillar Two

In general, Pillar Two adds complexity to the current system of tax rules. For example, implementing the proposal requires creating a new form of taxation on top of the existing system with its own tax base. Thus, one concern is how far the agreed system could be simplified. The proposal will increase administrative costs and may add to existing uncertainty regarding the taxation of profit. Such complexity and greater costs may limit adoption of Pillar Two. In addition, and partly due to the complexity, there may be ways in which MNEs can undermine the proposal through new forms of profit shifting. In this case, the gains from implementation would be significantly reduced.

One additional aspect of complexity is that the Pillar Two corporate income tax base calculations are based on financial statements. There is mixed evidence on the use of consolidated (*i.e.,* worldwide) financial statement income of the MNE as the tax base for determining the effective tax rate for purposes of the global minimum tax. One study finds descriptive evidence that book-tax conformity increases tax compliance.[288] The authors of the study argue that book-tax differences may be the result of not only differences between accounting standards and tax laws, but also be the decision to report lower net income for tax purposes and higher book income for financial reporting purposes.[289] In contrast, one paper reviews the literature on the elasticity of taxable income in the individual income tax context for the welfare analysis of Pillar Two's proposed use of financial statement income as a possible tax base for a global minimum tax on MNEs.[290] Assuming that the amount of profit shifting is a measure of economic efficiency, the author argues there is a relatively large responsiveness of financial statement income to taxes such that imposition of tax consequences on financial statement income may create a variety of distortions (*e.g.,* downward earnings management).[291] However, whether these distortions are true economic distortions or accounting distortions is unclear. Another paper finds evidence that increasing the conformity between accounting earnings and taxable income (*i.e.,* book-tax conformity) results in reported earnings that are less

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[288] K. Hung Chan, Kenny Z. Lin, and Phyllis L.L. Mo, "Will a Departure from Tax-Based Accounting Encourage Tax Noncompliance? Archival Evidence from a Transition Economy," *Journal of Accounting and Economics,* vol. 50, February 2010, pp. 58-73.

[289] *Ibid.*

[290] Dhammika Dharmapala, "The Tax Elasticity of Financial Statement Income: Implications for Current Reform Proposals," *National Tax Journal*, vol. 73 issue 4, December 2020, pp. 1047–1064. The welfare analysis is based on the Pillar Two public consultation document issued in late 2019.

[291] *Ibid.*

informative.[292] The authors argue that noise in earnings could increase with conformity because of managers' inability (because of the tax cost of doing so) to convey private information useful to external stakeholders through earnings.[293] Another paper argues that there are significant tax administration costs associated with using financial statements for tax purposes.[294] The authors argue that taxing authorities do not currently have the knowledge to administer and understand complicated financial accounting practices.

In general, Pillar Two puts a significant floor on tax competition. Competition by countries for inbound investment and inbound flows of profit is limited by the top-up tax of Pillar Two. Also, these floors on the tax on flows of both real activity and profit may also affect the choice of tax rates in other higher-tax headquartered countries.[295] Assuming that governments set their tax rates in response to those set elsewhere, a rise in the tax rate in one country may stimulate a rise in the tax rate in competitor countries. With the downward competitive pressure in higher-tax countries reduced by the global minimum tax, there may be higher statutory and effective tax rates in those countries.

The global minimum tax under Pillar Two may affect taxpayers' incentives with consequences for the distribution of profits or even for corporate income tax systems. The global minimum tax may reduce the intensity of multinational companies' profit shifting, in particular to tax havens, by reducing the tax rate differential. If multinational companies respond by shifting a part of their profits from tax havens to higher-tax jurisdictions, this reduces the amount of low-taxed corporate income. Due to heterogeneity in firm structures and aggressiveness in profit shifting, the effect on the geographical distribution of revenues is ambiguous.[296]

The substance-based income exclusion also affects the incentives of multinational companies and tax jurisdictions. The substance-based income exclusions may shield part of the undertaxed profits from the global minimum tax in proportion to payroll expenses and tangible assets. Using unconsolidated financial statements of foreign-owned EU subsidiaries of MNEs, one paper descriptively measures the share of pre-tax profit covered by the substance-based income exclusion for 2019 and finds an average ratio of substance-based income exclusion to

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[292] Michelle Hanlon, Edward L. Maydew, and Terry Shevlin, "An Unintended Consequence of Book-Tax Conformity: A Loss of Earnings Informativeness," *Journal of Accounting and Economics*, vol. 46, August 2008, pp. 294-311.

[293] *Ibid*.

[294] Michelle Hanlon and Michelle Nessa, "The Use of Financial Accounting Information in the OECD BEPS 2.0 Project: A Discussion of the Rules and Concerns," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 193-232.

[295] Michael P. Devereux, "International Tax Competition and Coordination with a Global Minimum Tax," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 145-166.

[296] Mona Baraké, Paul-Emmanuel Chouc, Theresa Neef, and Gabriel Zucman, "Revenue Effects of the Global Minimum Tax Under Pillar Two," *Intertax*, vol. 50, no. 10, 2022, pp. 689-710.

pre-tax profit of 57 percent.[297] With an adequate amount of real economic activity in a low-tax jurisdiction, profits can be taxed at an effective rate lower than the global minimum tax.[298] One article argues that by allowing countries to include a substance-based income exclusion, certain countries will be able to keep their tax rates low.[299] Specifically, the substance-based income exclusion undermines one of Pillar Two's goals to end tax competition by allowing some portion of foreign-source income not to be taxed so long as those countries attract jobs and investment.[300] That is, profit from real activities, as opposed to profit shifted into a country, may generate a relatively large substance-based income exclusion (up to five percent of (1) eligible payroll costs in the country and (2) the carrying value of eligible tangible assets in the country). In such cases, the top-up tax could be relatively small, and countries may therefore seek to continue to compete to attract such real activities. This creates an incentive for taxpayers to concentrate both their pre-tax profits and their real economic activity (*i.e.*, employees and tangible assets) in jurisdictions with lower income taxes. As a result, the effect of the substance-based income exclusion on tax planning practices and international tax competition may become more ambiguous.

In theory jurisdictions may be encouraged to tax MNEs solely through the QDMTT to collect revenue.[301] In general, jurisdictions that comply with Pillar Two may offer tax credits at the same time to preserve their competitiveness (*i.e.*, offset the top up taxes that an MNE located in their jurisdiction must pay).[302] Thus, the effectiveness of Pillar Two might be weakened by the introduction of such forms of tax credits by low-tax jurisdictions. The country that introduces them thereby preserves its fiscal competition feature without visibly having a low tax rate. This might lead to a tax credit competition, particularly with respect to refundable tax credits (as discussed in the following paragraph), among countries who would like to compete over attracting MNEs. Therefore, some jurisdictions that desire to attract real activity might adopt a combination of QDMTTs and investment attracting provisions.[303] In general, even though Pillar Two may reduce base erosion profit shifting, Pillar Two may also increase tax competition over other factors.

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[297] Michael P. Devereux, Johanna Paraknewitz, and Martin Simmler, "Empirical Evidence on the Global Minimum Tax: What Is a Critical Mass and How Large Is the Substance-Based Income Exclusion?," *Fiscal Studies*, vol. 44, no. 1, March 2023, pp. 9-21.

[298] Mona Baraké, Paul-Emmanuel Chouc, Theresa Neef, and Gabriel Zucman, "Revenue Effects of the Global Minimum Tax Under Pillar Two," *Intertax*, vol. 50, no. 10, 2022, pp. 689-710.

[299] Lilian V. Faulhaber, "Pillar Two's Built-In Escape Hatch," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 167-192.

[300] *Ibid*.

[301] Michael P. Devereux, "International Tax Competition and Coordination with a Global Minimum Tax," *National Tax Journal*, vol. 76, no. 1, March 2023, pp. 145-166.

[302] Mona Baraké, Paul-Emmanuel Chouc, Theresa Neef, and Gabriel Zucman, "Revenue Effects of the Global Minimum Tax Under Pillar Two," *Intertax*, vol. 50, no. 10, 2022, pp. 689-710.

[303] *Ibid*.

The OECD model rules differentiate between qualified refundable tax credits that are treated as income in the computation of Globe income and non-qualified tax credits that are treated as a reduction to covered taxes in the refund period. Because non-qualified tax incentives or tax credits reduce covered taxes, they may ultimately reduce the effective tax rate of an entity below the global minimum tax threshold. This differential treatment between qualified refundable and non-qualified tax credits may provide greater preference toward the use of qualified refundable tax credits. Whether this proves to be a significant factor for countries choosing their optimal tax systems remains to be seen.

Lastly, Pillar Two could have an important effect on the incentives to locate intellectual property ("IP") in low-tax jurisdictions. One study investigates whether firms locate their patents in tax havens. Primarily, the authors find evidence of disproportionate use of havens for both new patent applications and the purchase of existing patents.[304] In regard to Pillar Two, the authors find MNEs that meet the turnover-based size threshold requirements for the proposed global minimum tax (*i.e.,* MNEs with global revenues exceeding €750 million) are particularly active in developing patents: as of 2020 they constitute 2.6 percent of affiliates but are responsible for 42 percent of all patent applications and 45 percent of tax haven patents.[305] Also, the authors find that the revenue threshold under Pillar Two may be too high; the authors find that smaller MNEs with large subsidiary networks use tax havens much more prominently.[306] As such, firms below the Pillar Two suggested turnover-based size threshold may be involved in as much profit shifting using IP located in tax havens. As a consequence, even after broad enactment of Pillar Two, there may still be countries offering low-tax regimes to firms below the Pillar Two threshold.

4. Implications of Pillar One and Pillar Two Collectively

Because Pillar One remains under development and Pillar Two has only just begun to be enacted in member countries, there are not yet empirical studies analyzing the economic effects of either pillar. Therefore, this section largely focuses on qualitative discussions and revenue simulations related to the implications of both of these provisions.

In general, when Pillar One and Pillar Two are both enacted broadly, some of the incentives highlighted earlier may be mitigated. For instance, firms that may have shifted to low-tax jurisdictions in the presence of Pillar One will have less of an incentive to do so with the enactment of Pillar Two.

[304] Katarzyna Bilibka, Michael Devereux, and Irem Guceri, "Tax Avoidance Networks and the Push for a 'Historic' Global Tax Reform," in Robert Moffit (ed.), *Tax Policy and the Economy*, vol. 37, University of Chicago Press, 2022.

[305] *Ibid.*

[306] *Ibid.*

One paper estimates the direct effects of Pillar One and Pillar Two on MNE's effective tax rates.[307] In this paper the modelling of Pillar One focuses on Amount A, and the modelling of Pillar Two considers only the effect of the IIR. Covering over 70 jurisdictions that feature in the OECD Corporate Tax Statistics, the paper finds that Pillar One and Pillar Two would lead to modest increases on global weighted effective tax rates. In particular, the effects of Pillar One on effective tax rates are smaller, on average, than they are for Pillar Two, suggesting that changes to the overall investment levels due to Pillar One are likely to be limited; while the global weighted average effects of Pillar Two on effective tax rates remain modest, the effects will be more significant for MNEs operating in jurisdictions with effective tax rates below the minimum tax threshold.[308] In general, Pillar One and Pillar Two would appear to reduce the distribution of effective tax rates on investment projects across jurisdictions, thus increasing the relevance of non-tax factors in affecting investment decisions.

Using a combination of macroeconomic data from the World Bank and data from the OECD's country-by-country reporting ("CbCR") database, one paper estimates the effect of the initial announcement of the OECD Pillar proposals on shareholder value. The paper finds that MNEs that have a relatively high share of foreign-sourced income in low-tax jurisdictions experience significant negative stock returns that persist and increase over time.[309] In theory, it is unclear whether there would be strong price responses to the initial announcement of the OECD Pillar proposals. Investors might expect that MNEs would implement new tax planning strategies to circumvent an increase in tax burdens. However, the estimated effects suggest that investors valued previously successful tax planning strategies and expect the new rules to be effective in collecting more taxes from MNEs, possibly inducing MNEs to alter location and investment decisions.[310]

When simulating the revenue effects of Pillar Two only, one study considers two scenarios in regard to who collects the global minimum tax: (1) the country in which the headquarters are located based on the IIR or (2) the host country of foreign affiliates as laid out under the QDMTT. Using the OECD's tabulated CbCR statistics data, the study estimates that headquartered countries under the first scenario could collect a total revenue of €179 billion globally.[311] This analysis accentuates how the distribution of revenues varies depending on which country has the priority to collect. Revenues from Pillar Two might decrease if Pillar One is introduced alongside Pillar Two. This might happen because some revenues may be redistributed and taxed according to Pillar One and thus raise the effective tax rate of an MNE

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[307] Tibor Hanappi and Ana Cinta González Cabral, "The Impact of the Pillar One and Pillar Two proposals on MNE's Investment Costs," *International Tax and Public Finance*, vol. 29, November 2022, pp. 1495-1526.

[308] *Ibid*.

[309] Roberto Gómez-Cram and Marcel Olbert, "Measuring the Effects of the Global Tax Reform - Evidence from High-frequency Data," *Review of Financial Studies*, accepted, available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4052575.

[310] *Ibid*.

[311] Mona Baraké, Paul-Emmanuel Chouc, Theresa Neef, and Gabriel Zucman, "Revenue Effects of the Global Minimum Tax Under Pillar Two," *Intertax*, vol. 50, no. 10, 2022, pp. 689-710.

(assuming that the MNEs profits are not allocated to a low-tax jurisdiction). This effect would be limited to those MNEs that are in scope of Pillar One.

IV. BACKGROUND DATA

Public Law 115-97 reduced corporate tax rates and enacted multiple provisions specific to the U.S. taxation of cross-border activities. These changes were generally in effect for tax years starting in 2018. The staff of the Joint Committee ("Joint Committee staff") has reviewed data from recent tax filings to ascertain the impact of those changes.

A. Effect of Selected Provisions: GILTI, FDII, and the BEAT

The Joint Committee staff has examined preliminary aggregate taxpayer data for tax year 2018 and inspected a full sample of taxpayer returns for tax years 2018 and 2020 to provide some indication of the actual revenue effects of the international provisions in Public Law 115-97.

Table 1, below, contains data related to GILTI, FDII, and the BEAT for corporations in tax years 2018 and 2020. The data presented here are drawn from filings of Form 8991, Form 8993, Form 1118, and Form 1120. On Form 8993, corporations reported approximately $143.3 billion of FDII and $330.9 billion of GILTI in 2018, increasing to $176.9 billion and $406.5 billion in 2020. Section 250 deductions relating to FDII and GILTI were $52.5 billion and $186 billion in 2018, increasing to $66.7 billion and $223 billion in 2020. On Schedule C of Form 1120, corporations reported their GILTI inclusion amount as well as their total section 250 deduction. The total GILTI amount reported on Schedule C was $342.3 billion in 2018 and $437.6 billion in 2020. The reported section 250 deduction was $240.1 billion in 2018 and $308.5 billion in 2020.[312] On Form 1118, in 2018 their GILTI foreign taxes reported (after application of the section 960(d)(1) 80-percent limitation) were $37.7 billion and their GILTI foreign tax credits claimed were $24.2 billion. These values increased to $39.8 billion and $32.7 billion in 2020. The difference between the GILTI foreign taxes reported and GILTI foreign tax credits claimed is due to the section 904 foreign tax credit limitation. On Form 8991, despite the BEAT rate doubling from five percent in 2018 to 10 percent in 2020, total BEAT liability remained relatively stable at around $2 billion in 2018 and 2020. This may be because the average base erosion percentage,[313] which determines whether a taxpayer is subject to BEAT, fell from 8.4 percent to 2.9 percent.

[312] The discrepancy between (1) the reported totals for GILTI inclusion and GILTI, and (2) the reported totals for FDII and GILTI deduction and section 250 deduction results primarily from differences in the two data sources.

[313] A taxpayer's base erosion percentage for a taxable year is generally the percentage equal to the total amount of base erosion tax benefits of the taxpayer for that year divided by the sum of (1) the total amount of deductions allowable to the taxpayer for that year and (2) any base erosion tax benefits not reflected in (1), such as reinsurance premiums.

Table 1.–Amount of Items Related to GILTI, FDII, and the BEAT for Corporate Taxpayers[1], Tax Years 2018 and 2020 (Dollar Amounts in Billions)

	2018	2020
Source: Form 8993		
FDII	$143.3	$176.9
GILTI Inclusion	$330.9	$406.5
FDII Deduction	$52.5	$66.7
GILTI Deduction	$186.0	$223.0
Source: Form 1120 Schedule C		
GILTI	$342.3	$437.6
Section 250 Deduction	$240.1	$308.5
Source: Form 1118		
Total GILTI Foreign Tax	$37.7	$39.8
GILTI Foreign Tax Credits	$24.2	$32.7
Source: Form 8991		
BEAT Liability	$1.8	$1.9
Average Base Erosion Percentage	8.4%	2.9%

Source: IRS Statistics of Income and Joint Committee staff calculations. Data on the amount of FDII and the FDII deduction as well as the amount of the GILTI inclusion and the GILTI deduction are from Form 8993. The amount of GILTI is from Form 1120. The data on the section 250 deduction and the BEAT are from Form 1120. The average base erosion percentage is from Form 8991.

[1] For this table, these corporate taxpayers include entities filing forms 1120, 1120S, 1120-L, 1120-PC, 1120-F, 1120-REIT, and 1120-RIC.

Table 2, below, displays the number of corporate taxpayers by total asset size that reported a GILTI deduction, FDII deduction, or BEAT liability for tax year 2020. Approximately 7,000 of the 6.4 million corporate taxpayers who filed a tax return in the Form 1120 series for tax year 2020 reported either GILTI or FDII deductions and only 403 reported a BEAT liability. Among taxpayers reporting a GILTI inclusion, 59.0 percent had assets of less than $50 million, and among taxpayers reporting a GILTI or FDII deduction, 60.3 percent had assets totaling less than $50 million. In contrast, taxpayers reporting a BEAT liability were generally larger, with 66.3 percent of those taxpayers reporting at least $50 million in assets and 36.7 percent of those taxpayers reporting at least $1 billion in assets. Unlike GILTI and FDII, the BEAT has a gross receipts threshold that excludes smaller taxpayers from application of the tax. Because gross receipts generally correlate with invested assets, this may explain why the share of taxpayers with $1 billion or more in assets is higher for the data reporting BEAT liability versus data reporting GILTI and FDII.

Table 2.–Number of Corporate[1] Taxpayers with GILTI Inclusion, GILTI or FDII Deduction, or BEAT Liability by Total Asset Size, 2020

Total Assets	Number of Taxpayers			
	Overall[2]	GILTI Inclusion	GILTI/FDII Deduction	BEAT Liability
Less than $50 Million	6,354,591	4,018	4,238	135
$50 Million to $999 Million	39,681	1,848	1,814	119
$1 Billion or More	7,858	949	977	148
Total	6,402,130	6,815	7,030	403

Source: IRS Statistics of Income and Joint Committee staff calculations.

[1] For this table only, these corporate taxpayers include entities filing forms 1120, 1120S, 1120-L, 1120-PC, 1120-F, 1120-REIT, and 1120-RIC.

[2] The overall number of corporations includes purely domestic corporations that are unlikely to be affected by the three provisions.

B. Location of U.S. MNE Revenue, Assets, and Employees

This section presents evidence on the location of U.S. multinational enterprise ("MNE") activity around the world, using data from Form 8975 (Country-by-Country Report) for tax year 2020.[314] U.S. MNEs with revenues in excess of $850 million are required to file Form 8975 and report their unrelated party revenues, related party revenues, total revenues, profit or loss, income taxes paid on a cash basis, income taxes accrued for the current year, stated capital, accumulated earnings, number of full-time equivalent employees, and tangible assets in each jurisdiction in which they do business. In 2020, 1,788 taxpayers filed Form 8975.

The GAAP average tax rates ("ATRs") presented in Tables 3 to 7 are profit-weighted averages. These are calculated as the sum of taxes accrued within a jurisdiction divided by the sum of profits within a jurisdiction for entities reporting positive profit. To the extent that double-counting issues are present,[315] this is likely to result in tax rates which are biased downwards. To the extent that stateless income not subject to double counting was excluded from the analysis, this is likely to result in tax rates which are biased upwards. As an alternative, the median GAAP ATRs are also presented as the median is less sensitive to statistical outliers than the mean. These are the jurisdiction-level medians of entity level GAAP ATRs.[316]

Table 3, below, reports the 10 foreign jurisdictions where U.S. MNEs reported the greatest amount of unrelated party revenues for 2020.[317] Unrelated party revenues consist of revenue from third-party sales that require no transfer pricing. The top 10 jurisdictions in 2020 with entities of U.S. MNEs receiving such revenue make up 64 percent of total foreign unrelated party revenues reported on Form 8975. The list of jurisdictions includes some of the largest U.S. trading partners: the United Kingdom, Canada, China, Germany, Japan, and France. Profit-weighted average GAAP ATRs in these jurisdictions range from 4.5 percent in Switzerland to 29.5 percent in France. Profit-weighted median GAAP ATRs in these jurisdictions range from 11.1 percent in Singapore to 33.0 percent in Japan.

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[314] Form 8975 is required by Treas. Reg. sec. 1.6038-4 and includes both corporations and partnerships as the ultimate owner. Corporations are approximately 90 percent of the parent owners and report approximately 95 percent of the revenues. There are several important ambiguities to note when interpreting this data. MNEs can and do use a variety of financial reporting standards and can choose whichever one they would like to use for reporting information on Form 8975 (*i.e.,* if these MNEs have different permanent establishments with separate books that differ from the parent corporation). Consequently, what is included in the income and tax items will differ across MNEs. Despite a change from the original instructions for Form 8975, it appears that some taxpayers are reporting profits and related party revenues on an aggregate rather than a consolidated basis, leading to double counting in these data items. This is likely less of an issue for unrelated revenues, tangible assets, and employees which are the focus here. Finally, taxpayers were instructed to report income, assets, and employees for entities that are pass throughs or transparent for tax purposes in the jurisdiction as stateless. As a result, the Joint Committee staff dropped the stateless category from the calculations because otherwise there would be double counting of income.

[315] *Ibid.*

[316] The median ATRs are calculated as the average of the median observation, and the five closest observations on either side to prevent disclosure of taxpayer specific information.

[317] The data reported excludes amounts classified as stateless on Schedule A of Form 8975.

Table 3.–Top 10 Jurisdictions: Unrelated Party Revenues, 2020

Country	Share of Revenues (Percent)	Average GAAP ATR (Percent)	Median GAAP ATR (Percent)
United Kingdom	12.1	22.3	14.0
Canada	8.3	22.2	23.9
Ireland	7.8	12.6	12.2
China	6.5	22.5	21.8
Singapore	6.2	5.4	11.1
Japan	5.6	21.5	33.0
Germany	5.5	22.1	27.6
Switzerland	5.1	4.5	12.3
France	3.3	29.5	28.8
Australia	3.3	29.0	29.1

Note: Joint Committee staff tabulations of Form 8975 for tax year 2020. GAAP ATRs are calculated as the weighted average across all subsidiaries with positive profit in the jurisdiction. Share calculations include both profitable and loss subsidiaries.

Table 4, below, reports the 10 foreign jurisdictions where U.S. MNEs reported the greatest amount of tangible assets for 2020. The tangible assets reported by U.S. MNEs in these jurisdictions represent 56 percent of the foreign tangible assets reported on Form 8975. Similar to the table on unrelated party revenues, the profit-weighted average GAAP ATRs range from 5.4 percent in Singapore to 29.0 percent in Australia. Profit-weighted median GAAP ATRs in these jurisdictions range from 11.1 percent in Singapore to 33.0 percent in Japan.

Table 4.–Top 10 Jurisdictions: Tangible Assets, 2020

Country	Share of Tangible Assets (Percent)	Average GAAP ATR (Percent)	Median GAAP ATR (Percent)
United Kingdom	10.7	22.3	14.0
Canada	9.6	22.2	23.9
Australia	5.7	29.0	29.1
Ireland	5.5	12.6	12.2
China	5.2	22.5	21.8
Mexico	4.4	27.5	31.1
Germany	4.1	22.1	27.6
Singapore	4.0	5.4	11.1
Netherlands	3.8	7.7	18.6
Japan	2.9	21.5	33.0

Note: Joint Committee staff tabulations of Form 8975 for tax year 2020. GAAP ATRs are calculated as the weighted average across all subsidiaries with positive profit in the jurisdiction. Share calculations include both profitable and loss subsidiaries.

Table 5, below, reports the 10 foreign jurisdictions where U.S. MNEs reported having the greatest number of full-time equivalent employees in 2020. These top 10 jurisdictions make up about two-thirds of the foreign employees reported by these U.S. MNEs on Form 8975. The top 10 jurisdictions based on the number of employees is dominated by India, China, Mexico, the United Kingdom, and Canada. The profit-weighted average GAAP ATRs in these jurisdictions range from 22.1 percent in Japan to 29.5 percent in France. Profit-weighted median GAAP ATRs in these jurisdictions range from 14.0 percent in the United Kingdom to 33.0 percent in Japan.

Table 5.–Top 10 Jurisdictions: Employees, 2020

Country	Share of Total Employees (Percent)	Average GAAP ATR (Percent)	Median GAAP ATR (Percent)
India	12.5	27.2	26.2
China	9.6	22.5	21.8
Mexico	9.5	27.5	31.1
United Kingdom	9.4	22.3	14.0
Canada	7.1	22.2	23.9
Germany	4.0	22.1	27.6
Philippines	3.5	24.6	24.8
Brazil	3.5	27.3	30.2
France	2.6	29.5	28.8
Japan	2.6	21.5	33.0

Note: Joint Committee staff tabulations of Form 8975 for tax year 2020. GAAP ATRs are calculated as the profit-weighted average across all subsidiaries with positive profit in the jurisdiction. Share calculations include both profitable and loss subsidiaries.

Tables 6 and 7 report the top 10 foreign jurisdictions where U.S. MNEs report the largest related party revenues and profits in 2020. Because of concerns previously discussed in footnote 403 with regards to consolidation in reporting on Form 8975, these two categories appear to be problematic because they may capture amounts that are double counted.[318] For this reason, the Joint Committee staff do not report shares of the total foreign related party revenues or profits. Instead, because a ranking of jurisdictions may still be of interest, the Joint Committee staff lists the jurisdictions with related party revenues and net profits. The ranking is in order from largest to smallest amounts.

Table 6, below, shows the top 10 foreign jurisdictions, in descending order, in related party revenues. Compared to the top 10 jurisdictions receiving unrelated party revenues, as reported in Table 3, the top 10 jurisdictions receiving related party revenues are largely the same jurisdictions. For related party revenues, three new jurisdictions, the Netherlands, Luxembourg, and Mexico, displace Japan, France, and Australia among the top 10 jurisdictions. The profit-weighted average GAAP ATRs range from 0.9 percent in Luxembourg to 27.5 percent in Mexico. Profit-weighted median GAAP ATRs in these jurisdictions range from 1.2 percent in Luxembourg to 31.1 percent in Mexico.

Table 6.–Top 10 Jurisdictions: Related Party Revenues, 2020

Country	Average GAAP ATR (Percent)	Median GAAP ATR (Percent)
Ireland	12.6	12.2
Switzerland	4.5	12.3
Singapore	5.4	11.1
Netherlands	7.7	18.6
United Kingdom	22.3	14.0
China	22.5	21.8
Canada	22.2	23.9
Germany	22.1	27.6
Luxembourg	0.9	1.2
Mexico	27.5	31.1

Note: Joint Committee staff tabulations of Form 8975 for tax year 2020. GAAP ATRs are calculated as the weighted average across all subsidiaries with positive profit in the jurisdiction.

[318] OECD (2022). *OECD Disclaimer Country by Country Report Statistics,* OECD, Paris, https://www.oecd.org/tax/tax-policy/anonymised-and-aggregated-cbcr-statistics-disclaimer.pdf.

Table 7, below, reports the top 10 foreign jurisdictions,[319] in descending order, where U.S. MNEs report their greatest net profits for 2020. In contrast to the revenue tables (*i.e.,* Tables 3 and 6), the top 10 foreign jurisdictions for profits are dominated by relatively low-tax jurisdictions, those with the average GAAP ATR of U.S. MNEs' operations in those jurisdictions below 15 percent. Bermuda, Puerto Rico, and the Cayman Islands do not appear in any of the prior tables. Profit-weighted median GAAP ATRs in these jurisdictions range from 0.0 percent in both Bermuda and the Cayman Islands to 33.0 percent in Japan. In the cases of Switzerland, Singapore, Puerto Rico, Japan, and the Netherlands, the average GAAP ATR is significantly lower than the median, potentially a result of double counting issues in those jurisdictions.

Table 7.–Top 10 Jurisdictions: Net Profits, 2020

Country	Average GAAP ATR (Percent)	Median GAAP ATR (Percent)
Switzerland	4.5	12.3
Singapore	5.4	11.1
Ireland	12.6	12.2
Bermuda	0.7	0.0
United Kingdom	22.3	14.0
Puerto Rico	1.3	8.0
China	22.5	21.8
Cayman Islands	0.6	0.0
Japan	21.5	33.0
Netherlands	7.7	18.6

Note: Joint Committee staff tabulations of Form 8975 for tax year 2020. GAAP ATRs are calculated as the weighted average across all subsidiaries with positive profit in the jurisdiction.

[319] Puerto Rico, although a territory of the United States, is listed here as a foreign jurisdiction. For purposes of country-by-country reporting, a U.S. MNE must report information on related parties operating in another tax jurisdiction, including jurisdictions that have fiscal autonomy even if they are not sovereign. All U.S. territories are considered to have fiscal autonomy, so tax jurisdictions for the country-by-country report include Puerto Rico, U.S. Virgin Islands, Guam, American Samoa, and Northern Marianas. See Treas. Reg. sec. 1.6038-4(b)(7) and (10).

V. PILLAR TWO ECONOMIC ANALYSIS[320]

General Considerations for U.S. MNEs

As noted in Part II.B., Pillar Two seeks to establish a set of rules to enforce a minimum global level of income taxation for MNEs. The intent is to address MNE structures that allow for the shifting of profits into jurisdictions with low or zero tax rates. In February 2023, the OECD published administrative guidance on the Model Rules to address certain specific questions in need of clarification and simplification.[321] In general, for each country in which an MNE operates, the Model Rules calculate a top-up tax (which may be zero) on an income tax base derived from financial accounting principles.

As discussed in Part III.C., Pillar Two adds complexity to the current system of tax rules. There are numerous economic effects to consider when determining how much U.S. MNEs will be affected (*e.g.,* potential effect from QDMTTs and UTPRs in other jurisdictions). For example, many of the jurisdictions adopting Pillar Two already have a corporate tax rate of at least 15 percent, and thus adoption may not increase domestic taxes. This may limit the effect on U.S. MNEs and related CFCs operating in those jurisdictions. The adoption of UTPRs may have a significant effect for both U.S. MNEs and their CFCs in non-Pillar Two jurisdictions with average tax rates below 15 percent.

Many jurisdictions have agreed in principle to adopt Pillar Two, and some have already enacted legislation or have proposed legislation (see Appendix B for a list of Pillar Two enacting jurisdictions, hereafter referred to as "Pillar Two compliant jurisdictions"). Broad adoption of Pillar Two by other jurisdictions is likely to affect the behavior of MNEs, the Federal income tax liability of MNEs, and Federal income tax receipts. As discussed in detail below, all three results are related.

The implementation of Pillar Two in a significant number of jurisdictions will affect Federal tax receipts in two ways: first, by countries other than the United States taxing foreign-source income (mostly of CFCs) through a QDMTT that might otherwise be taxed in the United States; and second, by taxing U.S.-source income (mostly of U.S. corporations, whether U.S. MNEs or U.S. subsidiaries of foreign MNEs) through an IIR or UTPR. Table 8, below, reports the percentage of entities and the percentage of profit and losses of U.S. MNEs that may be affected by the Pillar Two compliant jurisdictions, if those jurisdictions were to implement Pillar Two (referred to here as a "Pillar Two jurisdiction"). Using the Country-by-Country Report for 2020, as reported on Form 8975, column one of the table presents the percentage of entities or income that could be directly affected by enactment of a QDMTT. Column two of the table presents the percentage of entities or income of U.S. MNEs that would either be directly impacted by a QDMTT or have nexus with a UTPR jurisdiction through another subsidiary of

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[320] The analysis set forth in this Part V is based on the Model Rules and related guidance as of July 11, 2023.

[321] OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two),* OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two.pdf.

the parent MNE. The table assumes that if a jurisdiction implements Pillar Two, that jurisdiction will also implement a UTPR that may affect any parent, sibling, or subsidiary of a U.S. MNE. IIRs are excluded from this analysis because the ultimate parent entity of a U.S. MNE that would apply an IIR would be in the United States, which has not adopted Pillar Two. U.S. MNEs with revenues in excess of $850 million are required to file Form 8975, which aligns closely with the revenue threshold for in-scope Pillar Two MNEs (€750 million, roughly $850 million). Overall, if the Pillar Two compliant jurisdictions were to implement Pillar Two, the Joint Committee staff estimates that 48.1 percent of entities, 49.4 percent of profit, and 40.9 percent of profit and losses of U.S. MNEs may be directly affected by the imposition of a QDMTT. Then assuming a UTPR is implemented as well, 98.9 percent of entities and 99.4 percent of both profit and profit and losses of these U.S. MNE's CFCs may be affected.

Table 8.–Potential Effect of Pillar Two Jurisdictions on U.S. MNEs, 2020[1]

	In Pillar Two Jurisdiction (Percent)	In Pillar Two Jurisdiction or UTPR Nexus Jurisdiction (Percent)
Share of Entities	48.1	98.9
Share of Profit	49.4	99.4
Share of Profit and Losses	40.9	99.4

Note: Joint Committee staff tabulations from Form 8975
[1] The total number of entities and the total amount of profit and losses do not include the United States and any stateless jurisdiction.

Scenarios

By design, Pillar Two is expected to raise ETRs worldwide. QDMTTs may raise ETRs in some jurisdictions, taxing income of CFCs that might otherwise be subject to residual U.S. tax. Several Pillar Two compliant jurisdictions currently have statutory tax rates of at least 15 percent, mitigating the direct effect of QDMTTs on Federal tax receipts. With respect to income of a CFC, IIRs of an intermediate jurisdiction will apply only in the absence of a local QDMTT and only after the allocation of any tax liability with respect to such income (*e.g.*, GILTI tax liability). Tax paid pursuant to an IIR is not expected to be creditable for U.S. tax purposes. UTPRs may affect Federal tax receipts in several ways, both with respect to U.S. and foreign-source income of U.S. MNEs. With respect to foreign income, UTPRs apply only in the absence of a local QDMTT and only after the allocation of any U.S. tax liability with respect to such income (*e.g.*, GILTI tax liability). Any tax paid pursuant to a UTPR is not expected to be creditable for U.S. tax purposes. Currently, there is temporary administrative guidance issued by the OECD that generally allocates GILTI tax liability to low-tax jurisdictions.[322] Upon its

[322] Administrative Guidance, Article 2.10. The special allocation method for purposes of allocating taxes arising under "blended CFC tax regimes" (*e.g.*, GILTI tax liability) generally results in the allocation of taxes to low-tax jurisdictions, which in certain situations may result in a local ETR close to 15 percent. In those cases, U.S. MNEs might not have any additional incentive to shift profits elsewhere.

expiration, U.S. MNEs may be subject to tax under both GILTI and Pillar Two (whether IIR or UTPR), with neither system providing credit for taxes paid under the other.

The adoption of IIRs and UTPRs in foreign jurisdictions could have significant effects on Federal tax receipts, driven by the response of U.S. and foreign MNEs. For example, U.S. MNEs facing the potential imposition of IIRs and UTPRs on foreign income may shift some amount of profits from low-tax non-Pillar Two compliant jurisdictions to high-tax jurisdictions, including Pillar Two compliant jurisdictions, where the ETR is approximately 15 percent. The magnitude of such a response, however, is highly uncertain.[323]

Key assumptions

The summary below describes possible changes in Federal tax receipts under several scenarios. The analysis rests on six assumptions. First, Pillar Two requires an ordering rule to determine the priority of taxing authority. The Joint Committee staff assumes the following ordering of priority: local corporate income taxes (including the CAMT, but excluding the CAMT on foreign income), QDMTTs, CFC rules (including GILTI, subpart F, and the CAMT on foreign income), IIRs, and finally UTPRs.[324] As a result of this ordering rule, domestic taxes are collected before collection by foreign jurisdictions under either CFC rules or the new Pillar Two provisions. Second, the Joint Committee staff assumes the Treasury will issue regulations indicating that QDMTTs are creditable and that foreign IIRs and UTPRs are not creditable. Third, State and local income taxes are included toward the Pillar Two computation of ETRs. Fourth, Pillar One will not be adopted within the budget window.[325] Fifth, the components of Pillar Two enacted by jurisdictions are consistent and uniform. Sixth, the United States does not enact tax legislation except as otherwise expressly provided herein.

The next two sections present several scenarios illustrating the range of effects on Federal income tax receipts.

First, the Joint Committee staff presents two results designed to illustrate the range of effects on Federal income tax receipts because of enactment of Pillar Two in the Pillar Two compliant jurisdictions (defined above). Understanding this range of effects is important in

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[323] The uncertainty arises in part from the various factors (tax and nontax) that companies consider as part of the cost of doing business. This includes nontax factors such as labor costs, local benefits, and supply chain costs.

[324] This ordering assumes that guidance will be issued as to how the CAMT liability with respect to foreign income should be allocated to CFCs and that such guidance will allocate such tax in the same way that the current Model Rules do for CFC Tax Regimes. The Administrative Guidance, however, appears to indicate that CAMT liability with respect to foreign income would not be allocated in the same manner as GILTI, a Blended CFC Tax Regime. See Model Rules, Article 4.3.2(c) (requiring any tax imposed pursuant to a CFC Tax Regime be allocated from the direct or indirect constituent entity owner that is subject to the CFC tax to the constituent entity through which the CFC income arose); Administrative Guidance, Article 2.10 (providing a simplified allocation method for purposes of allocating taxes arising under "blended CFC tax regimes," which do not include a tax regime that takes into account the group's domestic income).

[325] Pillar One of the OECD proposals would reallocate some taxing authority to market jurisdictions. In return, all participating jurisdictions have agreed not to apply digital services taxes.

formulating a modified baseline which accounts for the Pillar Two compliant jurisdictions and U.S. MNE responses to enactment in those jurisdictions. To show these effects, the two ranges reported below provide a lower and upper bound on revenues as compared to a hypothetical baseline that assumes no jurisdiction enacts any component of Pillar Two.

Second, the Joint Committee staff presents different forecasting scenarios ("forecasting scenarios") to show the effects on Federal tax receipts for different combinations of enactment of Pillar Two in jurisdictions other than Pillar Two compliant jurisdictions (the "remainder of the world") and/or the United States. For the forecasting scenarios, the revenue effects are compared to a modified baseline where the Joint Committee staff assumes enactment of Pillar Two by the Pillar Two compliant jurisdictions.[326]

Range of effects of Pillar Two enactment in certain jurisdictions compared to a hypothetical baseline

Below, the Joint Committee staff presents the effects of two illustrative results on receipts that are intended to represent upper and lower bounds for the effects of the implementation of Pillar Two on Federal income tax receipts. Each result is relative to a hypothetical baseline in which no jurisdiction has enacted or will enact Pillar Two. In contrast, both the upper and lower bounds assume that Pillar Two is implemented by the Pillar Two compliant jurisdictions.

The upper and lower bounds reported below demonstrate how sensitive Federal income tax receipts are to the assumptions made about behavioral responses of U.S. MNEs. Both results assume that U.S. MNEs subject to IIRs and UTPRs shift up to 75 percent of their low-tax profits to other jurisdictions. The key difference between the two results is where those profits are shifted. The lower bound assumes that U.S. MNEs shift up to 75 percent of their low-tax profits to Pillar Two compliant jurisdictions (namely, jurisdictions with a QDMTT). The upper bound assumes that U.S. MNEs shift up to 75 percent of their low-tax profits to the United States. The Joint Committee staff further assumes that the 75 percent of those profits shifted to the United States are profits that would otherwise be eligible for FDII. For both the lower and upper bound, profit shifting begins in 2025, along with the implementation of IIRs and UTPRs.

In addition, for the upper bound, because GILTI allows corporations to blend profits with losses, corporations would be expected to shift no more than the amount of profits exceeding losses. Therefore, the upper bound result assumes that U.S. MNEs shift the minimum of either (1) 75 percent of their low-tax profits or (2) the excess of global foreign positive profits over global losses.[327]

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[326] The modified baseline is the baseline that the Joint Committee staff uses for estimating proposals in 2023. As described above, this baseline is adjusted to reflect enactment of Pillar Two in Pillar Two compliant jurisdictions, as well as behavioral responses by U.S. MNEs in response to IIRs and UTPRs.

[327] This assumption is not necessary for generating the lower bound because any profits shifted are sheltered by losses under the GILTI regime, regardless of their foreign location.

Table 9, below, shows the revenue effects of these upper and lower bounds relative to a hypothetical baseline in which no jurisdiction has enacted or plans to enact Pillar Two.

Table 9.–Range of Effects of Pillar Two Implementation on Fiscal Year Federal Tax Receipts, Including Corporate Profit Shifting Responses (Dollar Amounts in Billions)

	2023-2028	2023-2033
Lower Bound	-$72.7	-$174.5
Upper Bound	$90.7	$224.2

As shown above in Table 9, the range of revenue effects is significant and highlights the uncertain effect Pillar Two implementation may have on Federal income tax receipts. In the lower bound, with U.S. MNEs assumed to shift their low-tax profits to QDMTT jurisdictions, any residual U.S. tax on those profits is eliminated by the corresponding allowable foreign tax credits. In the upper bound, with U.S. MNEs assumed to shift their low-tax profits to the United States, there is a significant increase in Federal tax revenues. The range of potential effects is meant to highlight the level of uncertainty here and is not meant to represent a likely outcome.[328]

The implementation of Pillar Two in one or more jurisdictions is expected to produce significant heterogeneity in responses across U.S. MNEs.[329] Some U.S. MNEs may shift a substantial portion of profits to Pillar Two compliant jurisdictions, while others may shift a substantial portion of profits to the United States. In addition, there still may be U.S. MNEs that do not shift profits out of low-tax jurisdictions. As stated above, there is temporary administrative guidance issued by the OECD that generally allocates GILTI tax liability to low-tax jurisdictions. As a result, after the allocation of GILTI tax liability, some corporations may not face an ETR that is significantly different from the 15 percent tax rate that they would face in a QDMTT jurisdiction and may decide not to alter their existing structures. U.S. MNEs may also have nontax reasons (*e.g.*, local benefits or incentives) for locating profits in these low-tax jurisdictions. In light of these heterogenous effects for U.S. MNEs, the Joint Committee staff assumes a modified baseline that is between those represented by the lower and upper bound results set forth in Table 9 (*i.e.,* not the hypothetical baseline). In particular, the Joint Committee staff assumed that 50 percent of low tax profits shift equally to Pillar Two compliant jurisdictions and the United States, with the bulk of the profit shifted to the United States eligible

[328] One important caveat to the range reported in Table 9 is that due to the assumption of a fixed GNP for conventional estimating purposes, the Joint Committee staff has not included any effect of the reduced incentive for foreign headquartered companies to shift profits out of the United States.

[329] The adoption of Pillar Two is likely to encourage countries (especially ones with low tax rates) to seek to attract local investment in new ways. For example, countries may choose to raise more tax revenue (through Pillar Two compliance) and then to return the revenue (perhaps to the same MNEs paying the tax) in the form of (tax and nontax) incentives. In theory, such incentives could offset the cost of any additional tax liability under Pillar Two. In this case, there would be less reason for U.S. MNEs to shift income into the United States and more reason to shift profits to Pillar Two compliant jurisdictions offering incentives.

for FDII.[330] This modified baseline is used for purposes of the forecasting scenarios below and is the 2023 working baseline for general revenue estimating purposes.

Forecasting scenarios

Below, the Joint Committee staff presents the effect on Federal income tax receipts of five different scenarios in which the United States and/or the remainder of the world (other than the Pillar Two compliant jurisdictions) enact Pillar Two.

The five forecasting scenarios are:

1. Remainder of the world enacts Pillar Two in 2025; United States does not.

2. Remainder of the world enacts Pillar Two in 2025; United States also enacts Pillar Two in 2025.

3. Remainder of the world does not enact Pillar Two; United States does not either.

4. Remainder of the world does not enact Pillar Two; United States enacts Pillar Two in 2025, but no U.S. UTPR.

5. Remainder of the world does not enact Pillar Two; United States enacts Pillar Two in 2025.

In each of these scenarios, the Joint Committee staff compares the results to the modified baseline in which (1) Pillar Two is fully enacted by the Pillar Two compliant jurisdictions; and (2) U.S. MNEs, as described above, respond by shifting some of their low-tax profits to both Pillar Two compliant jurisdictions and the United States.

For Scenarios 2 and 5, in which the United States enacts Pillar Two, the Joint Committee staff assumes that enactment of Pillar Two means enactment of (1) a compliant QDMTT at a 15 percent rate, (2) a compliant IIR (*i.e.*, a modified GILTI that is calculated (along with foreign tax credits) on a country-by-country basis at a 15 percent tax rate), and (3) a UTPR.[331] For Scenario 4, in which the United States enacts Pillar Two but not a UTPR, the Joint Committee staff assumes enactment of (1) a compliant QDMTT at a 15 percent rate and (2) a compliant IIR

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[330] In other words, 25 percent to QDMTT enacting jurisdictions and 25 percent to the United States. The revenue effects of this baseline relative to the hypothetical baseline in which no country enacts Pillar Two are not simply a weighted average of the results reported in Table 9. This is because the effects of each new dollar shifted to a Pillar Two compliant jurisdiction generates foreign taxes that have a diminishing ability to shelter pooled GILTI income. As a result, on net, the modified baseline loses revenue relative to the hypothetical baseline.

[331] Per the Model Rules, the UTPR would be levied at a 15 percent rate, and shared among Pillar Two compliant jurisdictions. For Scenario 2, in which all jurisdictions are Pillar Two compliant, QDMTTs become the primary mechanism for taxing relevant income and are the only component of Pillar Two that has any effect.

(*i.e.*, a modified GILTI that is calculated (along with foreign tax credits) on a country-by-country basis at a 15 percent tax rate).[332]

In Scenario 1, in which the remainder of the world enacts Pillar Two but the United States does not, the Joint Committee staff assumes a small decrease in profit shifting from low-tax jurisdictions to the United States relative to the modified baseline. Because the remainder of the world is Pillar Two compliant there is not a need to shift profits in anticipation of being subject to a UTPR.

In Scenario 2, in which the remainder of the world enacts Pillar Two and the United States does as well, the Joint Committee staff assumes a small increase in profit shifting into the United States relative to the modified baseline.

Scenario 3 is the modified baseline; thus, there is no revenue effect for this scenario.

In Scenarios 4 and 5, in which the remainder of the world does not enact Pillar Two but the United States does, the Joint Committee staff assumes a small increase in profit shifting into the United States relative to Scenario 2; the United States is now a potential location for profits that otherwise would have shifted to one of the Pillar Two compliant jurisdictions in order to avoid potential UTPR liability. Table 10, below, reports Federal fiscal year revenue effects for each of the scenarios relative to the modified baseline.

[332] An IIR compliant GILTI calculates liability on a country-by-country basis, and does not allow pooling of foreign taxes, losses, and QBAI across jurisdictions. All other aspects of GILTI remain as in present law. For instance, there is no change to the 20-percent reduction of foreign taxes for purposes of foreign tax credits. See sec. 960(d)(1). Similarly, the only substance-based income exclusion is the present law net deemed tangible income return with respect to QBAI. See sec. 951A(b)(2) and (d). In addition, the enactment of a QDMTT in the United States is layered on to the current law, including tax credits, FDII, BEAT, and CAMT. To the extent that these provisions lower/increase baseline revenues they increase/lower revenues from the enactment of a QDMTT.

Table 10.–Fiscal Year Federal Tax Receipt Revenue Effects for Various Scenarios of the Enactment of Pillar Two by the United States and/or the Remainder of the World, Relative to the Modified Baseline (Dollar Amounts in Billions)

	2023-2028	2023-2033
1. Remainder of the world enacts Pillar Two in 2025; United States does not enact.	-$39.2	-$122.0
2. Remainder of the world enacts Pillar Two in 2025; United States also enacts Pillar Two in 2025.	-$6.8	-$56.5
3. Remainder of the world does not enact Pillar Two; United States does not either.	---	---
4. Remainder of the world does not enact Pillar Two; United States enacts Pillar Two in 2025, but no U.S. UTPR.	$36.0	$102.6
5. Remainder of the world does not enact Pillar Two; United States enacts Pillar Two in 2025.	$98.2	$236.5

Scenarios 1 and 2 assume the remainder of the world enacts Pillar Two in 2025. In Scenario 1, the remainder of the world enacts Pillar Two, whereas the United States does not. The enactment of QDMTTs worldwide captures much of the residual U.S. tax on income earned in those foreign jurisdictions. Relative to the modified baseline, the loss of revenue from GILTI combined with the assumed decrease in profit shifting results in a revenue loss exceeding $120 billion over the budget window. In contrast, if the United States enacts Pillar Two in 2025, as in Scenario 2, the revenue loss is mitigated by increased receipts under the U.S. QDMTT, as well as a small increase in profit shifting into the United States relative to the modified baseline.

Scenarios 4 and 5 assume the remainder of the world does not enact Pillar Two (Pillar Two compliant jurisdictions aside). In Scenario 4, the United States enacts Pillar Two except for a UTPR, and in Scenario 5, the United States enacts all three components of Pillar Two, including a UTPR. In Scenario 4, enacting a U.S. QDMTT and making GILTI IIR compliant increase Federal income tax receipts by as much as $36 billion and $102 billion over five and 10 years, respectively. In Scenario 5, in which the United States also enacts a UTPR, receipts could increase by as much as $98.2 billion and $236 billion over five and 10 years, respectively. There are several factors contributing to the increase in revenue: (1) a Pillar Two compliant GILTI regime, (2) a compliant U.S. QDMTT, (3) revenue gained from a U.S. UTPR, and (4) a small increase in profit shifting into the United States relative to the modified baseline.

APPENDIX A: SELECTION OF DIGITAL SERVICES TAXES

Digital services taxes ("DSTs") refer to unilateral attempts by countries to impose taxes on the revenue generated by the digital activity of (largely) foreign multinational companies operating within their jurisdiction. Often, companies who generate digital revenue across many jurisdictions do not maintain a physical presence in the countries in which they operate. DSTs are a mechanism for taxing the activity of companies who might otherwise fall out of the country's income tax base. DSTs can target a range of digital activities, including advertising, streaming, the operation of intermediary services (such as online marketplaces), and the collection and sale of user data. For example, the United Kingdom's DST imposes a two percent tax on the revenue from online marketplaces, search engines, and social media platforms which derive value from United Kingdom users. Austria's DST imposes a five percent tax on revenues from digital advertisement services. Certain countries, like Colombia and Belgium, have proposed or enacted laws that deem a foreign company to have a significant economic presence ("SEP") if they provide digital services to domestic users. Companies with SEP status are subject either to the country's income tax or to a tax on their revenues. The below table gives an overview of some of the various DSTs proposed or enacted by countries.

Country	**Status**	**Effective Date**	**Type**	**Rate**
Argentina	Enacted	December 15, 2020	WHT	8 percent
Austria*	Enacted	January 1, 2020	DST	5 percent
Belgium	Waiting for Global Solution	Expected 2023 if global consensus is not reached	DST/Digital PE	3 percent
Brazil	Proposed	TBD	DST	1 percent – 5 percent (depending on revenue)
Canada	Proposed	January 1, 2024 (on revenues earned as of January 1, 2022)	DST	3 percent
Colombia	Enacted	January 1, 2024	SEP or alternatively WHT	10 percent WHT or 3 percent income tax
Republic of Congo	Enacted	January 1, 2021	WHT	10 percent
Costa Rica	Enacted	November 19, 2019	General income tax on digital tourist rental services income	N/A

Country	Status	Effective Date	Type	Rate
Czech Republic	Proposed (rejected)	TBD	DST	7 percent but may be reduced to 5 percent
Denmark	Proposed	TBD	DST	6 percent
France*	Enacted	1/1/2019	DST	3 percent
Hungary	Enacted	July 1, 2017 (Implementation delayed until December 31, 2023)	DAT	7.5 percent
India*	Enacted	April 1, 2022	SEP	N/A
	Enacted	April 1, 2020	DST	2 percent
	Enacted	June 1, 2016	DAT	6 percent
Indonesia	Waiting for Global Solution	March 31, 2020	Digital PE	N/A
	Waiting for Global Solution	March 31, 2020	DST	N/A
Israel	Enacted	April 11, 2016	Digital PE	N/A
Italy*	Enacted	January 1, 2020	DST	3 percent
Kenya	Enacted	January 1, 2021	DST	1.5 percent
Malaysia	Enacted	May 13, 2019	WHT	Variable
Mexico	Enacted	June 1, 2020	WHT	Variable
Nepal	Proposed	July 17, 2022	DST	2 percent
Nigeria	Enacted	February 3, 2020	SEP	6 percent
Pakistan	Enacted	July 1, 2018	WHT	10 percent
Paraguay	Enacted	January 1, 2021	WHT	4.5 percent
Peru	Enacted	January 1, 2007	WHT	30 percent
Poland	Enacted	July 1, 2020	DST	1.5 percent
	Proposed	TBD	DAT	5 percent
	Proposed	TBD	DST	7 percent

Country	Status	Effective Date	Type	Rate
Portugal	Enacted	February 17, 2021	Exhibition levy	4 percent
	Enacted	February 17, 2021	Annual levy	1 percent
Sierra Leone	Enacted	January 1, 2021	DST	1.5 percent
Slovakia	Enacted	January 1, 2018	Digital PE	N/A
Spain*	Enacted	January 16, 2021	DST	3 percent
Taiwan	Enacted	January 1, 2017	WHT	To be agreed with the tax authority
Tanzania	Enacted	July 1, 2022	DST	2 percent
Tunisia	Enacted	January 1, 2020	DST	3 percent
Turkey*	Enacted	January 1, 2019	WHT	15 percent
	Enacted	March 1, 2020	DST	7.5 percent but the President can reduce to 1 percent or increase to 15 percent
Uganda	Proposed	TBD	DST	5 percent
United Kingdom*	Enacted	April 1, 2020	DST	2 percent
Uruguay	Enacted	January 1, 2018	WHT	12 percent
Vietnam	Enacted	January 1, 2021	WHT	Variable
Zimbabwe	Enacted	January 1, 2019	General income tax on certain digital services income	5 percent

* Entered into agreement with the United States whereby the United States terminates tariffs imposed under Section 301 of the Trade Act of 1974 in exchange for country making any DST liabilities collected before the implementation of Pillar One creditable against future Pillar One taxes.
DAT: Digital Advertising Tax
DST: Digital Service Tax
PE: Permanent Establishment
SEP: Significant Economic Presence
WHT: Withholding Tax
Source: Joint Committee compilation from text of local country statutes.

APPENDIX B: SELECTION OF PILLAR TWO ENACTING JURISDICTIONS

Jurisdiction	Legislation	Status	IIR	UTPR	QDMTT
Canada	2023 Budget stated government's plan to introduce draft legislation implementing IIR and QDMTT, with UTPR to follow at later time, March 28, 2023.	Plan to Introduce legislation	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Yes (From December 31, 2023)
Japan	Japanese Parliament passed legislation which included the implementation of certain Pillar Two global minimum tax rules, March 28, 2023.	Enacted Law	Yes (From April 1, 2024)	No	No
Liechtenstein	Government published draft legislation and open consultation on measures to implement a global minimum tax, March 29, 2023.	Draft Legislation Published	Yes (From January 1, 2024)	Yes (From January 1, 2025)	Yes (From January 1, 2024)
South Korea	Korea enacted new global minimum tax rules to align with the OECD's Pillar Two Model Rules, December 31, 2022.	Enacted Law	Yes (From January 1, 2024)	Yes (From January 1, 2024)	No
Switzerland	Switzerland approved, by public vote, the introduction of Pillar Two in the form of a constitutional amendment, June 18, 2023.	Voted to amend constitution	Yes (From January 1, 2024)	Yes (From January 1, 2025)	Yes (From January 1, 2024)

Jurisdiction	Legislation	Status	IIR	UTPR	QDMTT
United Kingdom	Building on draft legislation published in July 2022, Finance (No. 2) Bill was introduced in the House of Commons and included measures to implement a ‘Multinational Top-Up Tax’, March 23, 2023; additional guidance, June 15, 2023.	Draft Legislation Published	Yes (From December 31, 2023)	Yes (No earlier than from December 31, 2024)	Yes (From December 31, 2023)
EU	Unanimous agreement on EU Global Minimum Tax Directive for the implementation of Pillar Two global minimum tax rules among member states, December 14, 2022.	EU Directive	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Optional for Member States

EU Member Countries

Germany	The German Federal Ministry of Finance published revised draft legislation to implement Pillar Two, July 10, 2023.	Draft Legislation Published	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Yes (From December 31, 2023)
Ireland	Ireland's Department of Finance published a Feedback Statement including possible draft legislation to implement the EU Global Minimum Tax Directive, March 31, 2023.	Feedback Statement	Yes (From December 31, 2023)	Yes (From December 31, 2024)	No (Intention to implement at later time)
Netherlands	Draft legislation sent to Parliament to implement Pillar Two, May 31, 2023.	Draft Legislation Published	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Yes (From December 31, 2023)
Sweden	Swedish Special Investigator submitted an interim report which included draft legislation for the implementation of the EU Global Minimum Tax Directive, February 7, 2023.	Draft Legislation Published	Yes (After December 31, 2023)	Yes (After December 31, 2024)	Yes (After December 31, 2023)

Note: Other jurisdictions who have either introduced, or plan to introduce, Pillar Two enacting legislation: Australia, Azerbaijan, EU member countries (Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Romania, Slovakia, Slovenia, and Spain), Guernsey, Indonesia, Jersey, Malaysia, Mauritius, New Zealand, Norway, Qatar, Singapore, South Africa, Thailand, United Arab Emirates, and Vietnam.

Source: *Joint Committee compilation from text of local jurisdiction statutes and Council Directive (EU) 2022/2523 of 14 December 2022.*