Pillar One's Reallocation of Taxing Rights: Has Anyone Consulted the U.S. Trade Representative?

BY JEFFERSON VANDERWOLK

The global tax policy process undertaken by the OECD/G20 Inclusive Framework on BEPS took a big step forward on July 1, 2021, when the group issued a statement, to which 130 of the 139 members subscribed, outlining the revised features of the Pillar One and Pillar Two plans that have been in development for the past two-and-a-half years. Two additional members have since signed up, bringing the total number in support to 132 jurisdictions. The seven remaining holdouts—Ireland, Hungary, Estonia, Kenya, Barbados, Nigeria, and Sri Lanka—are not political or economic giants, but three of them are EU member states, which creates a question as to the ability of the EU to implement the agreed proposals in due course.

In an interview with the International Fiscal Association, Pascal Saint-Amans, the director of the OECD's Center for Tax Policy and Administration, gave credit to the U.S. for pushing the process forward by presenting a revised proposal in April 2021 on Pillar One, which deals with the reallocation of taxing rights on certain profits of certain multinational enterprises (MNEs). Characterizing the previous debate on the scope of Pillar One as a "nightmare," he said the success of the U.S. proposal was due to limiting the scope to "the winners of globalization" in a manner that is "non-discriminatory."

Specifically, the agreement is that Pillar One will apply to multinational enterprises having annual turnover (i.e., gross revenue) of at least 20 billion euros ($23.8 billion) globally and a profit margin of at least 10% (presumably calculated on the basis of net profit before tax over gross revenue). A portion of the global profits of an in-scope MNE, in the range of 20-30% of their profit in excess of 10%, will be allocated for tax purposes among the countries from which the MNE derives at least 1 million euros ($1.19 million) in sales revenue (or, in the case of countries with GDP of less than 40 billion euros ($47.5 billion), at least 250,000 euros ($297,000) in sales revenue). The allocated amounts are designated "Amount A."

In exchange for the new rules on tax nexus and Amount A profit allocation, the countries of the Inclusive Framework have agreed to repeal existing digital services taxes (DSTs) and "other relevant similar measures." It is generally believed that they have also agreed not to enact any new ones, although that is not stated in the July 1 document. Currently the European Commission is asserting that it will proceed with the implementation of a new "digital levy" on income of certain highly digitalized MNEs, raising the question of whether the agreement to "remove" DSTs and other relevant similar measures includes a commitment not to put new unilateral measures in place in the future.

Earlier this year the Office of the U.S. Trade Representative (USTR) took action against countries with DSTs under Section 301 of the Trade Act, on the basis that the DSTs are "unreasonable or discriminatory and burden or restrict U.S. commerce." The reasoning behind this conclusion includes the following:

1. The DSTs are intended to, and by their structure and operation do, discriminate against U.S. digital companies, including due to the selection of services covered and the revenue thresholds.
2. The DSTs' application to revenue rather than net income contravenes prevailing tax principles and is particularly burdensome for covered U.S. companies.

Jeff VanderWolk is a partner at Squire Patton Boggs (US) LLP.

3. The DSTs' application to revenue unconnected to a physical presence in the taxing jurisdiction contravenes prevailing international tax principles.

4. The DSTs' application to a small group of companies contravenes international tax principles counseling against selectively targeting such groups for special, unfavorable tax treatment.

These findings were made by the USTR at the tail end of the Trump Administration, in mid-January 2021. However, in mid-March 2021 the newly appointed USTR, Katherine Tai, adopted the findings, and in early June 2021 she announced the imposition of retaliatory tariffs that would be deferred pending the outcome of the multilateral negotiations on Pillars One and Two.

U.S. Treasury Secretary Janet Yellen and other members of the Biden Administration have hailed the Inclusive Framework's near-total agreement on the two pillars as a triumph of economic diplomacy. The USTR, however, has so far said nothing publicly about the effect of the agreement on the deferred trade sanctions against countries with DSTs. Presumably the commitment to repeal existing DSTs will be sufficient grounds for the USTR to drop the deferred sanctions.

The more interesting question is whether the new nexus and Amount A reallocation rules of Pillar One will be acceptable to the USTR. The fact that the new rules are seen as a replacement for DSTs and other relevant similar measures suggests that the reallocation of taxing rights under Pillar One might have a similar effect to those unilateral measures. Looking at the USTR's reasons for finding that DSTs constitute a Section 301 violation, one finds a significant degree of applicability to the new nexus and profit allocation system of Pillar One.

Although it is not yet clear exactly how the criteria for defining the in-scope MNEs will be applied, it is generally believed that their number will be limited to around 100, the majority of will be U.S.-based, and those U.S.-based MNEs will be the source of the majority of the reallocated revenue. The new rules create taxing rights (i.e., nexus) on the basis of gross revenue and do not require any physical presence in the taxing jurisdiction. In all of these respects, the new rules contravene international tax principles, and would appear to be disproportionately detrimental to U.S.-based MNEs.

Many commentators, and some foreign government officials, have noted that the U.S. Congress's approval of the Pillar One and Two rules is far from certain. Perhaps the USTR will also have reservations about the Pillar One regime.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information *Jeff VanderWolk is a partner at Squire Patton Boggs (US) LLP. The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

Bloomberg Tax Insights articles are written by experienced practitioners, academics, and policy experts discussing developments and current issues in taxation. To contribute, please contact us at TaxInsights@bloombergindustry.com .