The Role of Tax Treaties in a Pillar I World

By Moshe Spinowitz*

I. Introduction

For nearly a century, income tax treaties have served as the primary—if limited—mechanism for coordinating cross-border taxation of business income in a manner that aims to avoid double taxation. It has traditionally done so through limited interference in the affirmative design of "local-country" tax regimes, and broadly-framed limitations on source-based taxation—whether through reduced gross basis withholding taxes or through limitations on the net basis taxation of business income *via* fairly standardized permanent establishment and associated enterprise articles.

The current phase of the OECD's ongoing Base Erosion and Profit Shifting initiative—often called BEPS 2.0—represents a potentially fundamental shift in the international tax framework, attempting a more far-reaching coordination among taxing jurisdictions in the design of their taxation regimes than has previously been attempted through the traditional treaty system. Of particular note, the first of the two "Pillars" that form the basis for BEPS 2.0 aims to expand source-based (or more precisely market-based) taxation of business income *via* a new taxation regime that departs from conventional cross-border taxation of income both in the measurement of business income and in the allocation of taxing rights with respect to that income.

The concepts underlying Pillar I taxation represent a new, fundamental challenge to the tax treaty system both because of their abandonment of the traditional limitations on taxation of cross-border business income, and because of the nature of the new tax that Pillar I, however precisely designed, would implement. On the one hand treaties will need to be revised to pare back certain of the core principles that have long animated the taxation of cross-border income, most notably the principles of separate entity accounting, arm's-length pricing, and limited taxable nexus. On the other hand, treaty partners will need to determine the extent to which the precise design of Pillar I taxation—both its affirmative design and the design of the correlative relief that will be needed to avoid double taxation—will be left to the treaty negotiation process (and perhaps the post-ratification "treaty

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regulatory process") vs. domestic law. In essence Pillar I proposes to carve back the scope of treaties and the traditional limitations imposed by treaties, thereby leaving a hole in the international tax system. How that hole is filled, and by whom, will in turn influence the design of Pillar I taxation, the role of treaties in that design, the relative authority of domestic taxing authorities vs. international coordinating bodies, and the prospects for double taxation in the international tax arena.

This article will first provide a brief overview of the Pillar I proposal set forth in the OECD's Public Consultation Document released in October of 2019. It will then explore certain of the policy and design questions left unanswered by the Public Consultation Document, not with a view to proposing resolutions to those questions, but as a prelude to considering the process *via* which those questions might be answered. These design questions, while prompted by the Public Consultation Document's proposal, are fundamental policy issues that will need to be addressed by any Pillar I-type proposal that aims to establish a new basis for cross-border income taxation based on the core principles articulated in the Public Consultation Document—that is, taxation based on group-wide (rather than entity-specific) income, and increased allocation of income to market jurisdictions.

Next, this article examines the approaches for implementing Pillar I taxation, in particular the prospects for affirmative implementation of Pillar I taxation and the impact that such implementation may have on the scope and relevance of income tax treaties. In essence, Pillar I taxation rests on the premise that current treaty-based restrictions on the taxation of cross-border business income will be relaxed, opening the door to the question of who will get to fill those gaps in a manner that balances the goals of certainty, administrability, national sovereignty, and prevention of double taxation.

Finally, assuming that a new Pillar I tax is implemented, appropriate correlative relief will be necessary to prevent double taxation. Accordingly, the final section of this article examines the design of the correlative relief that will be necessary to alleviate double taxation, and the U.S. tax implications of the various approaches to the design of such correlative relief. While the precise design of correlative relief is largely a question of domestic law (at least under the current treaty framework), Pillar I taxation presents new challenges for the design of correlative relief. These challenges present similar issues regarding the scope of tax treaties in a Pillar I world, and treaties' role in preventing double taxation while respecting traditional notions of national sovereignty in the design of national tax systems.

II. Pillar I Taxation—A Brief Overview

On October 9, 2019, the Secretariat released a public consultation document (the "Public Consultation Document") setting forth a Proposal for a "Unified Approach" under so-called "Pillar I."[1] The proposal traces its roots back several years to the OECD's Base Erosion and Profit Shifting Project, which identified "Addressing the Tax Challenges of the Digital Economy," as one of its action items.[2] A series of interim reports culminated in the May 2019 release of a Programme of Work, which set forth two "pillars" to address certain perceived gaps or shortcomings in the current approaches to the taxation of cross-border business income.[3]

The first "pillar," Pillar I, focuses on the need to revise concepts of taxable nexus and income allocation so as to ensure that more business income is "allocate[d] … to the jurisdiction of the customer and/or user."[4] The stated impetus for this policy change was a product of changing business models that permitted (i) the achievement of business scale without commensurate "mass"; (ii) increased reliance on intellectual property as a driver of business profitability; and (iii) in certain cases, increased reliance on user data and participation to generate business profits.[5] In addition, the proliferation of unilateral measures by various jurisdiction to address these challenges potentially threatened the international tax system through increased double taxation of cross-border business income.[6]

The approaches to addressing these developments outlined in the Programme of Work all shared certain key features including revising the current taxation rules to cause businesses to have a taxable presence in a jurisdiction without necessarily having a physical presence; allocating taxable income based on the overall profits of the business rather than the profits of any particular entity within a corporate group; and adopting simplifying conventions that would facilitate a more certain and formulaic allocation of profits. To that end the Programme of Work set forth three options for addressing Pillar I. The first, the so-called modified residual profit split ("MRPS") method, would allocate an "MNE group's non-routine profit that reflects value created in the market that is not recognized under existing profit allocation rules."[7] This method would involve a four-step procedure whereby a group would (i) measure its total group-wide profit, (ii) determine its "routine" profit, (iii) split its non-routine profit between marketing and other non-routine profits, and (iv) finally allocate non-routine "in-scope" profits to the relevant jurisdiction(s).[8]

The second approach—called the formulary apportionment approach—was similar to the MRPS approach except it would allocate *all* of the group's profits based on certain allocation keys, and would not purport to segregate routine and non-routine returns.[9]

The third approach, called the distribution-based approach, would not attempt to reallocate group-wide profits. Rather, hewing more closely to existing models for cross-border business income taxation, it would adopt new standards for determining acceptable levels of profitability for distribution entities operating (or perhaps deemed to operate) in the market jurisdiction, so as to ensure additional profits were allocated to the market jurisdiction, potentially including adjustments for higher or lower group-wide profitability.[10]

The Unified Approach to Pillar I outlined in the Public Consultation Document represents something of an amalgamation of all the approaches outlined in the Programme of Work. Under the Public Consultation Document, in-scope businesses—generally defined as "consumer-facing businesses" above some size threshold—would allocate their income among the various jurisdictions in which they operate and sell their goods under a new three-tier system, labeled as Amounts A, B, and C.[11] Taking them out of order, Amount B would represent a fixed return that would need to be earned by an entity conducting certain functions in a jurisdiction—most notably marketing and distribution functions, but perhaps other functions as well, such as research and development services or manufacturing activities.[12] Thus a limited-risk distribution entity within a corporate group that markets and distributes goods in Jurisdiction X would be entitled to earn at least some fixed return in that jurisdiction in consideration for its activities there.

Amount C would represent additional remuneration to which an entity is entitled if it performs certain functions beyond those compensated *via* Amount B.[13]

Finally—and perhaps most importantly—Amount A would represent a portion of the total income of a multinational business—generally measured based on consolidated financial reporting data—that is in excess of a "routine return." Such excess return would likely be calculated based on fixed formulas as well.[14] That portion of the group's excess return would in turn be allocated on a formulaic basis based on the group's relative sales (or users) in each applicable jurisdiction.[15] Put differently, to calculate Amount A, a corporate group would measure its total group-wide profit. Profits over a certain predetermined threshold—*e.g.*, profits in excess of a 10% operating margin—would be deemed "residual returns." A fixed percentage of those residual returns—*e.g.*, 10% or 20%—would be deemed attributable to the "market jurisdictions" in which the MNE group has its customers. That "market residual return" would then be allocated on a single sales-factor formulary apportionment basis—*i.e.*, allocated to each jurisdiction based on the portion of sales in that jurisdiction relative to the group's worldwide sales. The Public Consultation Document's Amount A thus has some elements of the MRPS approach and some elements of the formulary apportionment approach from the Programme of Work, while Amount B and (perhaps Amount C) reflects certain elements of the distribution-based approach.

What this high-level overview elides is the range of detailed policy decisions that are left unanswered by the Public Consultation Document. The following section highlights certain of those open policy questions and the issues involved, which in turn leads to a discussion of *who* will make those policy decisions and what implications that will have for the continued relevance and scope of the international tax treaty network.

III. Pillar I's Unified Approach—Some Questions Left Unanswered

As is perhaps evident from the Public Consultation Document, there are many key decisions left unanswered by the Public Consultation Document's high-level description of its proposal. This section will discuss a few of those open questions, not with the goal of providing specific policy recommendations, but rather to highlight the vast range of decisions that need to be made in designing a Pillar I tax, which in turn opens the door to the Pillar I implementation questions that are discussed in the following two sections.

a. Who—Pillar I's Consumer Facing Businesses

The first question that must be answered is *who* is subject to Pillar I taxation. In that regard it is clear that the Public Consultation Document contemplates some size threshold that would exclude smaller enterprises from the scope of the tax.[16] It is likewise clear that no industry-specific "ring-fencing" is contemplated by the Public Consultation Document.

Beyond that, the scope of the tax becomes less clear. The Public Consultation Document says that it will only apply to "consumer-facing businesses," with "consumers" defined in a brief footnote as "individuals who acquire goods and services for personal purposes (i.e., outside the scope of professional or business activity)."[17] Outside of the clearest examples of businesses selling purely consumer goods directly to consumers, the scope of "consumer-facing businesses" will require significant further delineation.

For example, there are many goods and services that are used or consumed by both "consumers" and "customers," with the Public Consultation Document defining the latter as generally including *all* purchasers of a good or service (including business customers that are not end-users).[18] The Public Consultation Document does not address the treatment of these types of "mixed-use" goods and services, into which category one might place a wide range of goods and services—computers, smartphones, many types of computer software, internet searching, transportation services, financial services, legal services, and the list goes on. In some instances, these goods and services might travel in different distribution channels when sold to businesses rather than consumers. In that regard, to the extent Pillar I permits any business-line segmentation in the measurement of Amount A, enterprises could potentially segregate their business-to-business segments from their business-to-consumer segments, with only the latter within scope. Of course, any type of segmentation presents a range of follow-on issues, some of which are discussed further below.

It is less clear how one would delineate where goods and services are sold through the same channels to both consumers and customers. One could adopt a "predominant character" type of test whereby goods and services that are predominantly consumed by consumers are treated as such even when sold to businesses. Alternatively, one could do some other type of rough delineation of revenues from "consumers" vs. "customers," although such delineation may need to vary by industry depending on what type of information is both available and relevant in the particular industry. In all events, countries imposing Amount A taxation (as well as those agreeing to cede taxation over a reallocated Amount A) will need to reach agreement regarding the treatment of mixed-use goods and services.

In addition to determining the treatment of mixed-use goods, a final design for a Pillar I tax will need to resolve on the treatment of "intermediate" goods and services. The Public Consultation Document is clear that final goods that are sold to consumers through distributors, whether related or unrelated, are within scope of the tax. Beyond that basic case, there is a broad range of non-final goods and services that are incorporated into final goods that are in turn sold to consumers, which are left unaddressed by the Public Consultation Document. This typically arises in two contexts—component parts that are incorporated into final goods and intermediate goods that are subject to further manufacture before ultimate sale. Neither of these scenarios is new to U.S. tax law. In the context of measuring subpart F income, the question of what constitutes "manufacturing" for purposes of Code Sec. 954(d)'s foreign base company sales income rules has long been debated, with some modicum of resolution having been brought to the area, albeit over time, *via* regulations under Code Sec. 954(d).[19] More recently, the new foreign derived intangible income ("FDII") regime enacted as part of the Tax Cuts and Jobs Act ("TCJA")[20] has given rise to further rules to determine when sale of a good that is incorporated into another good meets the requirements for "ultimate consumption" outside the United States so as to potentially be eligible for the beneficial tax rate applicable to FDII.[21] Whether, and to what extent, a final Pillar I proposal will adopt any of the U.S. approaches to what constitutes manufacturing and when to "trace through" a component part, or treat the sale of a component part as the sale of a "consumer good," all remains to be determined.

To the extent that non-final goods are treated as within the scope of the proposal, further rules will need to be crafted to determine the location of such sales. Since the Pillar I proposal requires an allocation of profit to the "market" jurisdiction, rules will need to address the location of sale of non-final goods—*i.e.*, place of sale of the intermediate good or place of sale of the final good into which the intermediate good is incorporated? And if the latter, how will the proposal address informational challenges faced by sellers of intermediate goods regarding the location of sales of the related final goods?

Finally, the proposal does not address the treatment of royalty income from the licensing of intellectual property that is incorporated into goods or services that are in turn sold or provided to consumers. There may be some licensing income that is earned through sales of goods to consumers where the product does not undergo further manufacture or transformation but is simply sold through a distribution channel—for example, certain media goods or software licenses.

But other licensing income may be earned with respect to intangible property where the ultimate good or service is clearly not the same "thing" as the licensed intangible property—pharmaceuticals being an obvious example. Is third-party licensing income intended to be within the scope of the Pillar I proposal?[22] If so, does the licensor have to have its own consumer-facing business to which the royalty income is allocated or is the consumer-facing business of the licensee imputed to the licensor? Further, whose sales are relevant in the geographical allocation of licensor's royalty income—licensor's own sales from other products it sells (if any) or licensee's sales? And if licensee's sales, is it only licensee's sale of the goods embodying the licensed IP or licensee's overall worldwide sales (which licensee presumably otherwise uses to determine the allocation of its Amount A). If it is the former, would licensee have to somehow specially allocate the cost of that royalty to the Amount A income that is allocated to certain jurisdictions with respect to that product, or would licensee simply treat the cost like any other expense that is effectively spread over all of its sales thereby creating a mismatch between the effective jurisdictional allocation of the royalty expense and that of the royalty income. If it is the latter, then licensor's allocation of its Amount A would be determined by sales of products that are completely unrelated to its licensing activity.

If, on the other hand, licensing income is carved-out of Pillar I taxation more broadly, a potential asymmetry is created between the taxation of income from the commercial exploitation of self-developed intellectual property vs. the commercial exploitation of licensed intellectual property.

A compromise path could draw lines based on the relative size of the royalty stream as compared to the sales of the product or the profitability of the product, or some other metric that attempts to include licensing income where the underlying intellectual property is a "large" portion of the value of the final good. But again, agreement would need to be reached on such line-drawing exercises.

b. How Much: Pillar I's Measurement and Allocation of Amount A

Once it is determined who is within scope of the new Pillar I taxation regime, the question becomes how to measure the income that is subject to reallocation under the Pillar I proposal. Or put more simply—how is Pillar I's Amount A measured and allocated. The Public Consultation Document indicates that the measurement of Amount A would be based primarily on a business group's financial accounting income, with a portion of the operating profits above a certain threshold subject to reallocation to "market jurisdictions" based on the proportion of the group's sales (or in certain cases users) in each jurisdiction. That is, the Amount A tax base would be based on financial accounting income, while the Amount A allocation would be based entirely on location of sales (or users).

The use of financial accounting income is presumably driven at least in part by the need to have a common tax base for determining Amount A so as to minimize the risk of double taxation. But the use of consolidated financial income as a basis for measuring residual taxable income leads to the question of what adjustments, if any, should be made to the computation of financial reporting income in determining Amount A. For example, what adjustments, if any, should be made in respect of non-wholly owned consolidated entities—*i.e.*, entities that are consolidated for financial reporting purposes (perhaps because of the level of control over that entity) but are not wholly-owned economically by the group. Or conversely, what about entities that are partially owned (perhaps even majority-owned economically) but are not consolidated for financial reporting purposes. Should Amount A reflect any of the income—or be allocated based on the sales—of such non-wholly-owned entities? And if they are excluded, does that potentially distort the measurement of Amount A or create incentives for corporate groups to own high margin businesses through non-consolidated subsidiaries?

Pillar I taxation, if it is to be implemented, promises to fundamentally alter the landscape for the taxation of cross-border income by abandoning (in part) the core principles of separate entity accounting and arm's-length pricing.

The Pillar I proposal would also need to address the treatment of both income and expense arising from non-ordinary course transactions, such as acquisitions and dispositions of businesses in M&A-type transactions. How, if at all, would gain or loss on the sale of assets or subsidiaries be included in the measurement of Amount A? Would such income be included in the measurement of the group's operating profits and thereby the measurement of its Amount A? If so, does that potentially thrust otherwise lower margin businesses into Amount A taxation by virtue of one-time transactions? And how would any such Amount A be allocated—would the future projected location of sales of the goods of the sold business be taken into account, or only actual sales by the relevant corporate group in the year at issue, which may bear no relation to the jurisdictional "nexus" of the sold business.

If such extraordinary transactions are excluded, how does (or should) that impact the measurement of the buyer's operating margins in circumstances where the buyer's income is reduced in respect of depreciation or amortization associated with the purchased business assets? If the seller's gain is effectively exempt from the Amount A measurement but the buyer's basis reduces its Amount A going forward, a potential mismatch is created, which in turn potentially distorts the incentives to engage in such transactions.

Similar questions apply with respect to intra-group transactions that are potentially taxable for "regular" tax purposes but are effectively disregarded in financial consolidation. For example, if one member of a corporate group sells certain intangible property to another in a taxable transaction, the seller may recognize taxable gain with respect to that asset sale and the buyer may be entitled to amortization deductions. But no such income or deductions would be recognized for financial accounting purposes. As a result, additional tax may be incurred in the selling jurisdiction upfront and less tax in the purchasing jurisdiction over time, but the Amount A measurement would be unaltered, with the potential for additional Amount A income being allocated to the selling jurisdiction, effectively allowing that jurisdiction to tax some of the profit twice—once *via* the taxable sale of the intangible property and again *via* the reallocation of Amount A.[23]

Finally, the bases for the measurement and allocation of Amount A in a particular year and to a particular jurisdiction will need to be determined. Amount A could be measured on a purely year-by-year basis, and could be allocated based exclusively on sales. Such an approach certainly has the benefit of simplicity. But a purely annual measurement of Amount A has all the standard shortcomings that infect annual tax accounting—*i.e.*, the distortions that arise from not being able to use attributes (losses, credits, *etc*.) that arise in one period in another. On the other hand, if some notion of loss carryforwards is introduced into the Amount A calculation—and presumably losses for this purpose would mean not just actual losses but any period with sub-routine returns—additional rules will be needed to determine the jurisdictional allocation of those losses, the period for carryforward, and the limitations on use of carried-forward losses.[24]

In terms of the jurisdictional allocation of Amount A, the Public Consultation Document proposes a pure sales-based apportionment, with Amount A allocated on a *pro rata* basis to each jurisdiction in which the taxpayer group sells its goods and services (perhaps with certain sales thresholds to exclude jurisdictions with low sales levels).[25] The Public Consultation Document does not contemplate any adjustments to the allocation of Amount A to reflect differential profit margins in various jurisdictions. By its nature, a pure sales-based apportionment has the potential effect of allocating taxable income towards lower-margin (and potentially loss-making) jurisdictions and away from higher-margin jurisdictions. As with purely annual accounting, sales-based apportionment has the virtue of simplicity; but perhaps less precision.

c. Pillar I Design—Thematic Considerations

If there are some common themes to be drawn from this laundry list of Pillar I questions, two come to mind: first, there is a clear trade-off between the precision with which Amount A taxation is levied, and the complexity of the rules implementing the new tax regime. Relatively simple, formulaic approaches could be adopted (*e.g.*, no consumer-facing limitation, no adjustments to financial accounting, purely annual measurements of Amount A, and a purely sales-based allocation of Amount A); but likely at the expense of achieving the purported goals of Pillar I. On the other hand, intricate line-drawing exercises may allow for a more precise targeting of the regime, but at the expense of simplicity. What impact these trade-offs in turn have on the stability and sustainability of the system is yet another question altogether.

Second, the more simple the rules for Pillar I taxation, the more readily those rules can be created *ex ante* and potentially agreed to by a broad range of taxing jurisdictions. The more complex and intricate the rules, the more complicated the "legislative" process, and the more expansive is the (perhaps inevitable) ongoing "regulatory" process to define the precise parameters of the Pillar I tax rules.

The following section explores certain of these implementation issues, with a focus on the intersection of Pillar I taxation and the existing tax treaty network, and the impact that Pillar I taxation may have on the existing approach to tax treaties.

IV. Treaty Implementation: Redesigning Treaties to Permit Pillar I Taxation

Pillar I—and in particular taxation of Amount A—represents a shift in the traditional approach that treaties take to the taxation of business income in two respects: an abandonment of the traditional nexus requirement for taxation of business income—*i.e.*, the permanent establishment requirement; and an abandonment of the arm's-length principle for determining the taxable income of a person with such nexus. Common to both of these is the abandonment of separate entity accounting as the basis for measuring the business income of an entity (or a PE) that is part of a larger corporate group. Under Pillar I, whether a corporate group is subject to Amount

A taxation in a jurisdiction does not depend at all on the group having any physical presence in the jurisdiction; sales to, or users in, the jurisdiction (perhaps above a certain threshold) are sufficient. Similarly, the profits or sales of any particular entity within the group are irrelevant in the measurement of Amount A. Rather Amount A, as described above, is measured and allocated based on the profit margins of the entire group (or perhaps a business segment within the group) and the relative proportion of the group's worldwide sales that are made to consumers in the applicable jurisdiction.

Before delving in to the treaty implementation of Pillar I taxation, it is worth pausing to note that U.S. implementation of Pillar I taxation would almost certainly require legislative implementation either *via* amendment to certain existing provisions, or *via* the imposition of a new statutory tax that implements Amount A taxation.[26] To the extent Amount A taxation requires taxing nonresident entities with no U.S. taxable presence under current U.S. tax rules, changes would need to be made to the rules regarding what constitutes the conduct of a trade or business within the United States under Code Sec. 864, which is the prerequisite for imposing net basis taxation on the non-FDAP business income of a non-U.S. person.[27] In the absence of at least some actual business activity in the United States, it is difficult to see how current law would permit the imposition of direct net basis taxation on a non-resident taxpayer.

To the extent Amount A requires taxing entities *with* a U.S. taxable presence on an amount of income that does not reflect the actual income of the entity, changes would presumably be needed to the income allocation rules of Code Sec. 482. Code Sec. 482 allows the Secretary to reallocate income among commonly-controlled entities if "necessary in order to prevent the evasion of taxes or clearly reflect the income of any such organizations, trades, or businesses."[28] This statutory authority has generally been understood to embody the arm's-length principle, "plac[ing] a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer."[29] Amount A taxation under Pillar I does not purport to be a measurement of the income of an entity that the entity would have earned had it conducted those same activities and transactions with uncontrolled taxpayers. To the contrary, the very premise of Pillar I taxation is that a given entity's income should *not* be based exclusively on the entity's income and activities, but rather should be based on the entire corporate group's income and activities. In other words, Pillar I expressly rejects Code Sec. 482's parity between controlled and uncontrolled taxpayers, instead measuring a taxpayer's income based precisely on its control relationship (most likely as determined under financial accounting consolidation principles) with other entities in a corporate group.

The U.S. statutory changes necessary to implement Pillar I taxation could thus be implemented either through changes to the above-mentioned statutory provisions themselves, or alternatively through a new "alternative minimum tax" that simply imposes additional tax to the extent the Amount A taxable income exceeds the taxable income as measured under "regular" tax rules. Whichever way the U.S. version of Pillar I Amount A taxation is imposed, it seems clear that implementing legislation will be required.

Turning to treaty implementation, the shift in the taxation of business income under Pillar I will require a change to—or override of—the three traditional treaty provisions—Articles 5, 7, and 9—that limit a jurisdiction's taxation of business income. Article 5 provides the traditional definition of a permanent establishment that forms the basis for a jurisdiction's taxation of the business income of a non-resident entity, and it requires some form of physical presence in the jurisdiction, either directly through an office or similar physical establishment or through activities of a dependent agent whose actions can be attributed to the taxpayer.[30] Article 7 in turn provides the operative limitation on the taxation of non-resident business income, limiting it to persons who carry on business in the jurisdiction through a permanent establishment and then further limiting the amount of income subject to taxation to the income that would have been earned by the permanent establishment if it were a separate enterprise engaged in the same activities, using the same assets, and taking on the same risks.[31] Articles 5 and 7, taken together, thus embody the physical presence requirement and arm's-length standard that Amount A taxation would violate.

Article 9—the Associated Enterprises Article—in turn permits a jurisdiction to adjust the taxable income of an entity that is otherwise subject to taxation in its jurisdiction in a manner that appropriately reflects the income that the entity would have earned had its related-party dealings been done on terms consistent with those that obtain between independent enterprises.[32] Or put simply—Article 9 permits a jurisdiction to make transfer pricing adjustments, consistent with the arm's-length principle, to the income of an entity that is otherwise subject to tax in its jurisdiction, while also requiring the counterparty jurisdiction to make appropriate correlative adjustments so as to mitigate double taxation of the relevant income.[33] As with Articles 5 and 7, Article 9 would likewise need to be narrowed, or overridden, so as to permit the imposition of Amount A taxation without regard to the arm's-length principle that is embodied in Article 9.

The Public Consultation Document acknowledges Pillar I's abandonment of these core treaty principles, and concludes that while Articles 5, 7, and 9 will need to remain in place to govern the taxation of business income more generally, they will need to be modified so as to permit Amount A taxation.[34] But the Public Consultation Document leaves unanswered the question of the extent to which Amount A taxation is implemented *via* income tax treaties themselves and the process for doing so.

Given that the restrictions imposed by Articles 5, 7, and 9 on the taxation of both resident's and non-residents' business income will need to be carved back to make space for the imposition of Amount A taxation, the question becomes who precisely gets to fill that space. Traditionally, tax treaties themselves did not provide the precise terms for, or conditions of, local country taxation. Tax treaties may *limit* local country taxation (either *via* limitations on withholding taxes or *via* the limitations on the taxation of business income under Articles 5, 7, and 9), but they generally do not impose tax in the first instance or attempt to define, other than in broad strokes, the parameters of such taxation.[35] A similar approach could be adopted with respect to Pillar I taxation. In other words, treaties could broadly craft the contours of a Pillar I tax that would be permissible under tax treaties *via* the contraction of Articles 5, 7, and 9, but leave it to each applicable jurisdiction to precisely define Pillar I (and in particular Amount A) taxation, including potentially what businesses are in scope and how Amount A is measured and allocated.

This "treaty minimalist" approach in essence represents a retraction in the scope of tax treaties that effectively leaves increased space for individual countries to design non-resident taxation in a manner that is neither restricted, nor prescribed, by tax treaty. Such an approach requires less coordination (at least upfront) between and among treaty partners and preserves a greater scope for individual countries to design a Pillar I tax as they see fit. Of course, the flipside of reduced coordination and greater jurisdictional sovereignty is an increased risk of double taxation. If one country imposes Amount A taxation in a manner that it considers consistent with the Pillar I principles, while the counterparty refuses to grant correlative relief with respect to a tax that it views as *inconsistent* those principles, double taxation would presumably result.

As a procedural matter, that risk can be mitigated through more effective dispute resolution procedures—whether binding arbitration between (or among) the parties, or neutral third-party dispute resolution. But it is not entirely clear how such dispute resolution would work where countries simply have different views on the scope of Amount A taxation. If, for example, Country A thinks a certain business is consumer facing and Country B does not; or Country A wants to impose Amount A taxation on a particular business segment whereas Country B calculates residual returns on a group basis; or Country A uses pure financial statement income and Country B makes various adjustments, it is not clear how—or on what basis—those disputes would be resolved. In other words, without a common substantive framework for Pillar I taxation, the dispute resolution procedure may be left to falter.

That proposition needs to be caveated, however, as it is conceivable that case-by-case adjudication could be used over time to develop a sort of "common law" of Pillar I taxation. Or put differently, *ex ante* coordination would be limited, but over time, through the adjudicative process, a certain amount of convergence could be achieved in the design of Pillar I taxation so as to both increase certainty and minimize double taxation. This process may bear certain similarities to the elaboration of the permanent establishment standard and arm's-length principle over time through treaty dispute resolution procedures or through commentaries, technical explanations, and other fora for elaborating the meaning of treaty provisions outside of the context of treaty-ratified text itself. If competent authority proceedings can be said to create a "common law of treaties," at least as a *de facto* matter, then one could at least consider leaving the development of Pillar I taxation to a similar (likely long-term) process.

Alternatively, in contrast to traditional treaty practice, the precise contours of Pillar I taxation—both the affirmative imposition of the tax and the necessary correlative relief—could be defined through the treaty process with a detailed Pillar I taxation regime as the sole permissible regime that can "fill the gap" left by the carve-back on the limitations of Articles 5, 7, and 9. Rather than leaving treaties to the role of *limiting* taxation in accordance with broadly-drafted principles, treaties would effectively impose affirmative taxation in accordance with a detailed "statutory" scheme; in essence, a treaty-based alternative minimum Amount A tax. To the extent design decisions are made upfront, countries could implement them through their typical legislative procedures, which in the case of the United States would presumably include both "regular" statutory implementation through the traditional legislative process as well as treaty implementation through the treaty negotiation and ratification process.

Such a "treaty maximalist" approach would expand the traditional office of tax treaties by leaving to treaties the affirmative design of (at least some) cross-border business income taxation. Experience suggests, that such a detailed regime is likely to require not only detailed design upfront, but also elaboration over time through the typical "gap filling" regulatory process. Thus, a treaty maximalist approach would require not only an initial adoption of a detailed taxation system through the tax treaty network, but also a coordinated "regulatory" process for providing additional rules over time. Jurisdictions would effectively need to cede authority over the design of Amount A taxation (and perhaps correlative relief) to such a regulatory body. No doubt, forms of agreed dispute resolution would still be needed to resolve case-by-case disagreements among treaty partners; but the aim of this approach would be to minimize such *ex post* disputes through greater *ex ante* coordination and common rulemaking.

Without here delving into the constitutional questions involved in choosing among the above delineated paths, including the question of how much taxing power may be imposed *via* tax treaty[36] and how much treaty interpretation authority might be delegated to non-judicial bodies,[37] the question of "who gets to decide" also necessitates a series of policy decisions regarding which governmental bodies are given the authority to design and effectively implement Pillar I taxation—whether national legislative bodies, regulatory bodies, administrative adjudicatory bodies, or international or multilateral intergovernmental agencies. These choices present a trade-off between jurisdictional autonomy and design flexibility on the one hand and tax certainty and double taxation relief on the other.

Pillar I implementation thus presents a new challenge to the treaty system—if Pillar I taxation is to be implemented successfully in a coordinated manner that affords tax certainty and avoids double taxation, treaties will need to be given wider berth in the precise design and implementation of cross-border taxation of business income. Alternatively, if such coordination cannot be achieved, treaties will potentially have a more limited role in allocating taxing authority among countries, and thereby in preventing double taxation.

These questions—while primarily procedural—are not unrelated to the substantive policy decisions highlighted in the preceding section. The complexity of the Pillar I tax system depends in large part on the contours of the tax and the level of precision that is attempted in the design of the tax. The more tailored the tax in its scope—the more carve-outs and caveats and adjustments—the more design coordination is required (and to the extent not achieved, the more risk of double taxation). On the other hand, the less targeted (and intricate) the tax is in its design, the easier it should be to achieve coordination regarding its implementation. The trade-off between design precision and design simplicity, on the one hand, is thus necessarily linked to the trade-off between tax coordination and tax sovereignty on the other. The decisions on both of these trade-offs will necessarily determine whether treaties play a broader role in the coordination of cross-border taxation or whether the role of treaties is left to contract in the face of Pillar I taxation.

V. Pillar I Taxation and the Design of Correlative Relief Through a U.S. Lens

a. Introduction

Having discussed certain of the issues involved in designing and implementing a system of taxation under Pillar I, the question becomes how would—or should—countries provide for correlative relief so as to prevent double taxation of the Amount A income that is reallocated to another jurisdiction under Pillar I. This section explores that issue through the specific lens of various approaches to correlative relief that could be made available under U.S. domestic law—either as it currently exists or as it might be revised in response to the imposition of Pillar I taxation. The precise design of U.S. correlative relief can yield dramatically different results to U.S. corporations or U.S.-parented multinational groups whose income is reallocated to another jurisdiction, whether it is from the U.S. to a non-U.S. jurisdiction, or from one non-U.S. jurisdiction to another. And while the answer to the question is partly a mechanical one—*i.e.*, simply a question of what adjustments can be made to reflect the reallocation of Amount A—it also potentially reflects (or at least can reflect) a conceptual understanding of the policy underlying Amount A taxation. One's preferred approach to correlative relief may be driven in part by one's theory of Amount A reallocation. In addition, one's preferred approach to correlative relief may depend on the precise design of Pillar I taxation—in particular which entities within a corporate group are liable for the Amount A taxation—the coordination of which may in turn depend on the answers to the questions discussed in the preceding section.

The following discussion sets forth three potential approaches to correlative relief to reflect reallocation of income under Amount A. Each approach presents a range of secondary questions and tax results in terms of the measure of an entity's taxable income, the rate of tax applicable to the relevant income, the foreign tax credits available to mitigate U.S. taxation of that income, and various other tertiary consequences arising from the potential adjustments (or lack thereof) in respect of Amount A taxation. The effectiveness of each approach in mitigating double taxation also depends on the design of Pillar I taxation, requiring a coordination between the design of Pillar I taxation, whether through tax treaties of otherwise, and the design of correlative relief.

That in turn raises the same set of questions discussed above regarding the adoption of a "treaty minimalist" or "treaty maximalist" approach. Tax treaties have generally afforded countries significant discretion and flexibility in their design of correlative relief regimes.[38] If the precise design of Pillar I taxation is articulated through tax treaties, the design of correlative relief could similarly be mandated through treaties, potentially minimizing double taxation at the expense of also further restricting jurisdictional sovereignty with respect to the design and implementation of domestic tax law. Alternatively, if treaties leave the details of Pillar I design to individual countries, the design of correlative relief would presumably be similarly unprescribed, potentially exposing multinational enterprises to greater double taxation. In all events, from a policy perspective, both Pillar I taxation and correlative relief should be designed in a manner that maximizes the possibility of avoiding double taxation, potentially through the incorporation of priority rules or taxpayer/taxing authority elections that permit the correlative relief system to adapt to the design contours of Pillar I taxation, or *vice versa*.

This section first outlines the current U.S. approach to correlative relief, then outlines three potential approaches to Amount A correlative relief, and finally explores the various secondary and tertiary consequences of the various approaches to correlative relief through illustrative examples. In the context of exploring these approaches to correlative relief, this section will also explore certain design features of both Pillar I taxation and correlative relief that can mitigate double taxation through the appropriate interaction of these two treaty-based regimes.

b. Correlative Relief—A Brief Overview of Current Law

The United States' current approach to correlative relief is effectively a mixture of exemption for, and credit in respect of, income and the related taxes, that are subject to taxation in a foreign jurisdiction under a bilateral income tax treaty. Where a U.S. person that does not otherwise have a taxable presence in a non-U.S. jurisdiction transacts with a related non-U.S. person, under both U.S. domestic law (Code Sec. 482) and bilateral income tax treaties (Article 9, Associated Enterprises) the terms of such transactions must be consistent with the terms that would obtain in a similar transaction between unrelated parties—*i.e.*, arm's-length terms. If such transactions are not on arm's-length terms, and as a result the income of the U.S. person is overstated and that of the counterparty understated, then under Article 9 of an applicable tax treaty, the United States is obligated to make "appropriate adjustments to the amount of the tax charged therein" to reflect the reduced taxable income of the U.S. person. That is accomplished by adjusting the terms of the relevant transaction in a manner that has the effect of reducing the taxable income of the U.S. person, and increasing the taxable income of the non-U.S. counterparty. Those so-called primary adjustments have the effect of exempting the income that had been reported by the U.S. person from U.S. taxation.[39]

For example, if a U.S. person had incurred costs of $50 in manufacturing a good, and it then sold that good to a non-U.S. affiliate for $80, the U.S. person would report $30 of taxable income. If it is determined that $80 was in excess of the arm's-length price for that good, and it is agreed that an appropriate price was $70, the U.S. person's taxable income would be reduced from $30 to $20, effectively exempting from U.S. taxable income that portion of the income that is "shifted" *via* the transfer pricing adjustment to the non-U.S. affiliate.[40] The U.S. person does not need to rely on a foreign tax credit to avoid double taxation since the foreign-taxed income is effectively exempted from (direct) U.S. taxation *via* the transfer pricing adjustment.

Alternatively, if a U.S. person is determined to have a taxable presence in a non-U.S. jurisdiction because it operates in such jurisdiction *via* a permanent establishment as defined in Article 5 of the applicable treaty, then the non-U.S. jurisdiction is permitted to levy tax on the business profits that are attributable to that permanent establishment. In that circumstance, however, because the United States does not exempt the permanent establishment's income from U.S. taxation, the U.S. person must rely on the foreign tax credit mechanism to mitigate double taxation of that income. U.S. bilateral income tax treaties generally obligate the United States to grant a tax credit in those circumstances, albeit "[i]n accordance with the provisions and subject to the limitations of the law of the United States."[41] While some treaties bolster the effectiveness of that relief through the resourcing of such income—*i.e.*, mandating that income (subject to variation across treaties) that is subject to non-U.S. taxation under a treaty be treated as foreign source income for U.S. foreign tax credit limitation purposes—others do not.[42] So in the above example, if $10 of the U.S. person's $30 of taxable income was determined to be allocable to a permanent establishment in a non-U.S. jurisdiction, the U.S. person would still have $30 of taxable income, but would be able to claim a credit in respect of the non-U.S. income tax levied on that $10, subject to all of the applicable limitations that apply to the use of foreign tax credits under U.S. tax law.

c. The Three Alternatives

With this background in mind, one could describe (at least) three potential approaches that can be used to address the reallocation of Amount A income, two of which are familiar to current law, and a third that would represent a new approach to relief from double taxation under U.S. law. The first approach we will call the "Do Nothing Approach." Under the Do Nothing Approach, where Entity A earns income in one jurisdiction that becomes subject to taxation in another jurisdiction *via* an Amount A reallocation, no further adjustments are made to the taxable income of Entity A. Essentially, Amount A taxation is left to operate in the same manner as any other form of foreign taxation of business income, with the primary (if not exclusive) mechanism for relief from double taxation being the availability of a foreign tax credit. No other "primary adjustments" would be made *via* any transfer pricing adjustments in respect of the transactions (if any) between relevant affiliates. This is most similar to the current law approach to the taxation of income earned by a U.S. person through a permanent establishment.

The second approach is the "Transfer Pricing Approach." Under the Transfer Pricing Approach, adjustments would be made to the terms of any relevant transactions between affiliated parties—perhaps on a retrospective basis—in a manner that results in the "proper" amount of income being earned in the local affiliate in the jurisdiction to which the Amount A income was reallocated. Thus, for example, if Entity A sold goods to affiliated Entity B at an arm's-length price, and it was ultimately determined that Entity A earned residual returns that are subject to taxation in jurisdiction B pursuant to an Amount A reallocation, the transfer price for the goods sold from Entity A to Entity B could be reduced so as reduce the taxable income of Entity A and increase that of Entity B to the extent necessary for Entity B to have earned the relevant Amount A income. This approach is most akin to the transfer pricing adjustments that obtain today where affiliates are deemed not to have transacted on arm's-length terms. But such adjustments would now be expanded beyond such arm's-length adjustments, and would also apply to Amount A reallocations between and among affiliated entities.

Finally, the third approach, which has no analogue in current U.S. law, we will call the "Exemption Approach." Under this approach, where one entity earns income in Country A that is subject to tax in another by virtue of an Amount A reallocation, that income would be exempted from tax in Country A. No transfer pricing adjustments would be made and no foreign tax credits available in respect of the tax paid to the foreign jurisdiction. Rather—as with a branch exemption system—the income that is reallocated to another jurisdiction pursuant to an Amount A reallocation would simply be exempt from taxation (either *via* exemption or a 100% deduction) in the jurisdiction in which the income was actually earned.

d. The Three Approaches in Action

i. Example 1 and the Coordination of Pillar I Taxation and Correlative Relief

We can begin the illustration of the three approaches with a simplified example that is a slight variation on the illustration included in the Public Consultation Document[43]:

> **Example 1.** USP is a U.S. corporation that is in the business of making and selling widgets. USP owns CFC that is resident in Country X. Neither USP nor CFC has a taxable presence in any jurisdiction other than its place of incorporation under conventional tax principles. USP manufactures widgets and sells them to CFC. CFC in turn sells those widgets to consumers in Country X and Country Y. USP incurs costs of $30 in manufacturing the widgets and sells them to CFC for $60. CFC incurs $35 of expense in marketing and distributing the widgets and sells $100 of widgets to third-party customers—$50 of which are sold to consumers in Country X and $50 to Country Y consumers.

In the above example, before any adjustments, USP earns $30 of income ($60 from the related-party sale of the widget minus $30 of expenses), and CFC earns $5 ($100 of income from the third-party sales minus $35 of marketing and distribution expenses and the $60 related-party purchase price). Group-wide profit is $35, and assuming a "normal return" of 10% of sales (which would be $10 in this case), the residual income is $25. Assuming further that 20% of residual returns are included in Amount A, $5 of income would be subject to reallocation, with $2.50 taxable in Country X (in addition to CFC's $5 of "regular" income) and $2.50 in Country Y.

Under the approach outlined in the Public Consultation Document, since the USP group has an entity in Country X, Country X could impose the additional tax on either USP or CFC. However, since the USP group does not have any taxable presence in Country Y, the Public

Consultation Document appears to suggest that Country Y can tax only USP, but not CFC. Given the proposed approach to levying the Amount A tax, the results to USP can differ significantly under each of the three approaches to correlative relief outlined above.

Under the Do Nothing Approach, no "primary adjustments" would be made; USP would still have $30 of taxable income and CFC would have $5 of taxable income. Assume for present purposes that all of CFC's income is tested income within the meaning of Code Sec. 951A. USP's $30 of income would be subject to full U.S. taxation, with the potential for a reduced rate on some or all of that income by virtue of the 37.5% deduction currently available for foreign derived intangible income under Code Sec. 250(a)(1)(A), while the $5 of CFC income would be eligible for reduced taxation as a result of the 50% deduction for GILTI under Code Sec. 250(a)(1)(B). USP's pre-credit U.S. tax liability would thus be unchanged under the Do Nothing Approach.

If Country X chooses to levy the Amount A tax on CFC (as permitted under the Public Consultation Document), the first question would be whether USP can claim a credit in respect of that foreign tax. No direct tax credit would be available under Code Sec. 901 since the tax is levied on CFC, and the tax would only be creditable under Code Sec. 960(d) if it is properly allocable to the tested income of CFC.[44]

Even if the tax is creditable under Code Sec. 960(d), it would be subject to the 80% haircut under Code Sec. 960(d)(1). In addition, with only $5 of taxable income in CFC, and no adjustment to tested income in respect of the Amount A reallocation, USP may effectively be unable to use the additional foreign tax credit due to the Code Sec. 904 limitation on USP's foreign tax credit utilization. If Country X's tax rate is 20%, CFC would pay $1 of "regular" tax and would owe an additional $0.50 on the reallocated Amount A. Given that CFC has only $5 of tested income, however, USP would only have capacity to use $0.525 of foreign tax credits (calculated by multiplying the $5 of tested income by the effective GILTI tax rate of 10.5% and assuming USP has no other GILTI inclusion income and that none of USP's expenses are allocable to such income) under Code Sec. 904, given that foreign source tested income and associated taxes are now segregated in a separate foreign tax credit limitation basket under Code Sec. 904(d)(1)(A). Thus, in effect, USP does not obtain any double taxation relief in respect of the Amount A tax levied by Country X on CFC; the Amount A tax is simply a marginal cost incurred by the USP group. And because Code Sec. 960(d) credits cannot be carried forward, USP will *never* be able to use such credit.[45]

Alternatively, if Country X levies the tax on USP, as permitted under the Public Consultation Document, the foreign tax would give rise to a credit under Code Sec. 901 that can be claimed directly by USP. But such credit would still be subject to the foreign tax credit limitations under Code Sec. 904, which requires that USP have foreign source income in order to be able to use the credit. In the first instance, on these facts, USP would not have any such income since under Code Sec. 863(b), as amended by the TCJA, USP's income from the sale of goods manufactured in the United States is treated as U.S. source income, notwithstanding that it is all sold for consumption outside the United States. Thus, absent an applicable treaty resourcing provision, USP would again be unable to utilize the credit, and would simply face a marginal tax cost in respect of the Amount A reallocation. Although in this scenario, at least the credit can be carried forward to future years.[46] Alternatively, if a treaty resourcing provision applies, a portion of USP's income may be recharacterized as foreign source income, albeit such income and the related tax would be placed in a separate foreign tax credit limitation basket under Code Sec. 904(d)(6). If USP was otherwise paying a reduced rate of tax on that income as a result of an available FDII deduction, and Country X imposes a 20% tax on such income, USP may face a higher tax cost, albeit not necessarily due to double taxation of the income.

Finally, under the Do Nothing Approach, given that there are no primary adjustments to the taxable income of USP and CFC, there are also no secondary adjustments needed, and the after-tax cash of both USP and CFC remains unchanged, with no other actual or deemed transactions between the two entities. Likewise, the taxable income of USP is unchanged for all other purposes of the Code, such as measuring USP's adjusted taxable income and its resulting interest limitation under Code Sec. 163(j), or its modified taxable income and resulting BEAT tax liability under Code Sec. 59A.

Under the Transfer Pricing Approach, if Country X levies the tax on CFC, USP and CFC would be permitted (or perhaps obligated) to redetermine the price at which USP sells widgets to CFC in order to yield the "proper" amount of Amount A income at CFC. Focusing again on Country X, since CFC has an Amount A reallocation of $2.50, USP would reduce the price at which it sells widgets to CFC by that amount. USP would have $2.50 less of taxable income and CFC that much more. The reduction in USP's taxable income would reduce its pre-credit U.S. tax liability. CFC would have an additional $2.50 of tested income giving rise to an additional $1.25 of taxable income at the USP level (assuming full availability of the

50% deduction under Code Sec. 250(a)(1)(B)). Given the transfer pricing adjustment, presumably the additional $0.50 of tax (20% of $2.50) incurred by CFC is treated as properly allocable to tested income, and USP would be allowed to claim a credit of $0.40 (80% of $0.50) under Code Sec. 960(d). Assuming USP is not otherwise limited in its use of those credit, those credits would potentially fully offset any additional U.S. tax incurred on that additional GILTI inclusion.

Whether the USP group comes out ahead or not, will be highly sensitive to the magnitude of the Amount A reallocation, the relative rates applicable to such income in the United States and the relevant foreign jurisdiction, and USP's ability to utilize the additional Code Sec. 960(d) "GILTI" foreign tax credits derived from CFC. But at least, under this approach, the income is only being taxed initially in a single jurisdiction—*i.e.*, Country X—and USP can achieve an effective exemption in respect of the Amount A reallocation *via* the transfer pricing adjustment.

Given the primary transfer pricing adjustment between USP and CFC, secondary adjustments are necessary as well to align the accounts of USP and CFC with the adjusted transfer price. Essentially, USP has $2.50 of excess cash in its possession as a result of CFC's "overpayment" for the widgets. Applying U.S. principles, CFC would either need to be deemed to have paid a $2.50 dividend to USP, or USP would be deemed to owe CFC $2.50. In the former scenario, a current withholding tax would potentially be due with respect to that dividend, and while USP likely would not recognize any additional taxable income in respect of that dividend (since generally it would be paid out of previously taxed earnings and therefore not be taxable under Code Sec. 959(a)), it may be able to claim a credit in respect of that withholding tax. In the latter scenario (*i.e.*, creating a deemed payable from USP to CFC), USP would have to remit cash (eventually) to CFC in settlement of that payable, presenting the same withholding tax issues albeit on delay. If USP leaves the note outstanding for a period of time, it would accrue interest on the note which would presumably be taxable in Country X, and would effectively not be deductible in the United States since the corresponding income in the CFC would be taxable as subpart F income under Code Sec. 954(c)(1)(A). And the additional Country X tax may not be effectively creditable since the interest income would be U.S. source interest income in the first instance under Code Sec. 861(a)(1). In short, while the Transfer Pricing Approach may be successful in preventing the double taxation of the reallocated income, the resulting secondary adjustments could result in additional tax inefficiencies to the USP group.

Finally, while the Do Nothing Approach avoided the "tertiary" consequences that arise from shifting taxable income from USP to CFC, the Transfer Pricing Approach presents all those consequences. For example, the reduction in USP's taxable income from $30 to $27.50 in our example reduces its 163(j) limitation by 30% of that adjustment. Likewise, USP would have to adjust both its "regular" taxable income and its modified taxable income for BEAT purposes.

The third approach—the Exemption Approach—would attempt to avoid double taxation while avoiding both the shortcomings of the foreign tax credit mechanism relied upon by the Do Nothing Approach, as well as the secondary adjustments that are the byproduct of the Transfer Pricing Approach. Under the Exemption Approach, USP would simply exempt from its taxable income any amount in respect of the Amount A reallocation. Because the reallocated Amount A income is exempt from U.S. tax, no credit would be available in respect of the foreign taxes levied on that income. CFC's income for U.S. tax purposes would thus be unchanged, as would USP's income inclusions under Code Sec. 951 and 951A as well as the credit available under Code Sec. 960(a) and (d). The sourcing of USP's income in respect of the Amount A reallocation becomes irrelevant, and thus the presence or absence of a treaty resourcing provision is equally irrelevant. USP is also indifferent as to whether the tax is levied at the USP or CFC level, because in either event no credit is allowed in respect of that tax. And because no transfer pricing adjustments are made, there are no secondary adjustments that are necessary and no deemed loan or dividend from CFC to USP. In essence, the Exemption Approach avoids double taxation without needing secondary adjustments, and without needing to rely on the credit mechanism at either the USP or CFC level, with all of its imperfections, in particular those arising from the sourcing mismatches discussed above and the purely annual nature of Code Sec. 960(d) credits.

The Exemption Approach would also appear to address the issues arising from both the optionality given to taxing authorities with respect to Amount A taxation where there is a local-country affiliate (*i.e.*, the Public Consultation Document permits taxation of *either* the local affiliate or the residual income earner), as well as those arising from the imposition of Amount A taxation where the group has no traditional taxable presence in the relevant jurisdiction. With respect to the former, under either the Do Nothing or the Transfer Pricing Approach there is a potential mismatch between the location of the taxable income and the tax. Under the Do Nothing Approach, Country X can impose tax on the CFC while the taxable income (for U.S. tax purposes) is at USP; and the reverse is true under the Transfer Pricing Approach. Arguably that can be addressed by adopting an approach that aligns the location of the tax with the location of the income. That is, if the tax is levied at the CFC level (in our example) then you apply the Transfer Pricing Approach, while if the tax is levied at the USP level you apply the Do Nothing Approach.

But it is far less clear how the Transfer Pricing Approach would work in the case of the Amount A taxation imposed by Country Y (in our example). Per the Public Consultation Document, since the USP group does not have a taxable presence in Country Y, Country Y would impose the tax on USP—the entity that earns the residual return. In that case, the Do Nothing Approach raises all the same issues as discussed above, most notably the sourcing mismatch issue that impacts the likely effectiveness of the foreign tax credit. And the Transfer Pricing Approach would yield a mismatch between the location of the tax (USP) and the location of the income (CFC).

The Exemption Approach, in contrast, would relieve double taxation by exempting the reallocated Amount A from the taxable income of USP without any need (or ability) for USP to claim a credit in respect of the additional Country Y taxes. Nor would any secondary adjustments be necessary, since such adjustments are never necessary under the Exemption Approach.

Essentially the Exemption Approach functions without regard to where the tax is levied, which per the Public Consultation Document may vary from jurisdiction to jurisdiction and even case by case, and without regard to the source of the reallocated income, the rate of tax imposed on such income, or the effective credibility of any Amount A tax. It is worth noting, however, that the "tertiary" effects of exempting a portion of USP's income continue to apply—*e.g.*, the measurement of USP's interest limitation under Code Sec. 163(j).

What this example—and the application of the three approaches to it—illustrates is that Pillar I taxation must either be implemented in a manner that can be coordinated with the design of correlative relief, or correlative relief must be designed flexibly to adjust to the design and implementation of Pillar I taxation. If Pillar I taxation is designed in a manner that gives taxing jurisdictions flexibility to choose where to impose Amount A taxation, then effective correlative relief will likewise need to be flexibly designed to align the correlative relief with the location of the tax. That may either counsel in favor of allowing taxpayers to choose their correlative relief approach (whether Do Nothing or Transfer Pricing) or instead may counsel in favor of adopting the Exemption Approach, which self-adjusts to the location of the Amount A taxation. But either way, the correlative relief regime would need to be designed to match the flexibility of the Pillar I regime.

Ultimately, if the Pillar I design choices are prescribed *via* treaty, including the rules regarding which entities in the group must bear the Amount A tax, the traditional treaty approach to correlative relief—*i.e.*, granting a fair amount of flexibility to countries in their design of correlative relief—may continue to be acceptable. If, however, a more "treaty minimalist" approach is used to implement Pillar I taxation, then treaties will either need to be more prescriptive in the design of correlative relief (so as to mitigate double taxation) or countries will need to enact more comprehensive and flexible correlative relief regimes to accommodate the variability of Pillar I taxation. Absent such coordination, the variability of Pillar I taxation on the one hand, and the "fixed nature" of typical correlative relief regimes, on the other, will likely result in increased double taxation.

ii. Example 2: Pillar I Taxation and Multi-Party Correlative Relief

A slight variation on Example 1 further illustrates the complexities involved in designing correlative relief in circumstances where multiple members within the corporate group participate in the transactions that give rise to an Amount A allocation.

> **Example 2.** USP is a U.S. corporation that developed certain technology related to the design and manufacture of widgets. USP owns CFCx and CFCy, which are resident in Countries X and Y, respectively. USP licensed its IP to CFCx. CFCx further developed that IP and manufactures the widgets for sale to CFCy. CFCy sells the widgets to consumers in Country Y. USP receives a royalty from CFCx equal to 15% of net third-party sales of the widgets. CFCx incurs $30 of expense in the manufacture of the widgets and sells them to CFCy for $60. CFCy incurs $35 of expense in marketing and distributing the widgets and sells $100 of widgets to third-party customers in Country Y.

As in example 1, the USP group earns total operating profits of $35, which is earned $15 by USP, $15 by CFCx, and $5 by CFCy, before any adjustments. Assuming that a "normal return" would be $10 (10% of sales), the group's residual income is $25. Assuming further that 20% of residual returns are included in Amount A, $5 of income would be subject to reallocation to Country Y.

Given the three-party transaction implicated by the Amount A reallocation in this fact pattern, the correlative adjustments necessary to prevent double taxation become more complex and more uncertain. Under the Public Consultation Document, it is clear that Country Y may impose Amount A taxation on CFCy. It appears relatively clear—although perhaps not fully certain—that it can impose Amount A taxation on CFCx, the party that is both in direct contractual privity with CFCy and that earns at least part of the residual return. It is unclear whether Country Y can impose Amount A taxation on USP—a party that earns a portion of the residual return from the sale of goods to Country Y consumers, but that neither has a taxable presence in Country Y nor contracts directly with a Country Y entity.

Under the Do Nothing Approach, there would be no adjustments to the U.S. taxable income of any of the entities involved. If Country Y taxes CFCy, we are left with the same issues faced in Example 1 where the Amount A tax was imposed on the limited risk distributor: Is the tax creditable (*i.e.*, it is properly attributable to tested income) and will USP have the capacity to use the credit? Assuming the answer to the first question is yes, there is perhaps greater hope on question 2, since the residual income in CFCx effectively can be combined with that of CFCy in determining the foreign tax credit limitation of USP with respect to its overall GILTI inclusion. Thus, even if CFCy would generate excess credits on a stand-alone basis, the excess income at CFCx (in particular if Country X provides at least some double taxation relief and thereby lowers the tax that it levies on CFCx) may be used by USP to absorb those credits. But it would appear unlikely that Country X would fully cede taxing rights over the full Amount A, given that a portion of the residual return is earned by USP. Thus absent other correlative adjustments to the income of CFCx and USP, the Do Nothing Approach would leave at least a portion of the income subject to double taxation.

Similarly, if Country Y chooses to levy the Amount A tax on CFCx, as long as CFCx provides its own double taxation relief, the result for USP is largely unchanged from the status quo. Both the income and taxes of CFCx and CFCy would be unchanged (but for any rate differential between Country X and Country Y), and all the income of the USP group would be subject to single—rather than double—taxation. But again, as above, that presumes that Country X grants full correlative relief in respect of the Amount A taxation by Country Y, which it may well not since CFCx only earns half of the residual return.

Finally, if Country Y chooses to impose the Amount A tax on USP, the Do Nothing Approach would permit a credit for that tax on Code Sec. 901, but USP would potentially be limited in its ability to use that credit. In this fact pattern, the licensing income is foreign source income in the first instance. But USP is only earning half of the residual return; and depending on the relevant Country Y tax rate, USP may not have capacity to claim a credit for the full Amount A tax where it only earns half of the residual income *via* the intercompany royalty.

The Transfer Pricing Approach is relatively straightforward as applied to the transaction between CFCx and CFCy in Example 2. The transfer price of the widget must be reduced from $60 to $55 in order to yield an additional $5 of taxable income at CFCy (assuming that Country Y has chosen to impose taxation on CFCy). But the question then becomes what transfer pricing adjustments should be made to the transaction—i.e., the royalty payments—between USP and CFCx. The Public Consultation Document is simply silent on that question and it is not clear what standard should obtain: The arm's-length standard? Some other basis for splitting the Amount A reallocation that has the effect of shifting residual return away from USP and CFCx? Or *ad hoc* resolutions between the relevant jurisdictions *via* treaty dispute resolution procedures?

Given the nature of the tax treaty system, the simpler the Pillar I tax the more feasible it is for it to be implemented through the treaty network; and conversely, the more complex and nuanced the system, the more difficult the treaty implementation and the more likely that jurisdictional variability will result.

In Example 2, the Transfer Pricing Approach also gives rise to the need for secondary adjustments that effectively must move—in the example—$5 from USP and CFCx on the one hand to CFCy on the other. The secondary adjustment between USP and CFCy raises all the same concerns (deemed dividend with a withholding tax or interest-bearing loan) that were discussed above under Example 1. The secondary adjustment between CFCx and CFCy, in turn raises additional issues. If cash needs to move from CFCx to CFCy and the two entities are in a brother-sister relationship, the deemed distribution and contribution may give rise again to a current withholding tax in respect of the deemed distribution from CFCx, with the resulting cash deemed contributed to CFCy where, if not needed, it could attract a further withholding tax upon distribution to USP. Alternatively, a note owing from CFCx to CFCy could avoid (temporarily) any withholding tax inefficiencies, but the interest payable could give rise to local-country tax inefficiencies if the interest income is fully taxable and the deduction cannot be fully utilized, and could potentially give rise to U.S. tax inefficiencies as well if for example the interest income becomes subpart F income following expiration of Code Sec. 954(c)(6) (currently in effect through 2020).

In the case of Pillar I taxation, the questions of who gets to decide and what can plausibly be decided are inextricably linked, with the traditional concepts of tax sovereignty and the role tax treaties standing in the balance.

The Exemption Approach can address some—but certainly not all—of these issues. As discussed above, it eliminates the need for secondary adjustments and reduces (if not eliminates) the need to rely on the highly imperfect foreign tax credit mechanism to mitigate double taxation. But the Exemption Approach does not solve the problem of allocating the "exempt income" between USP and CFCx. Under any conceivable approach, three-party transactions that give rise to Amount A allocations will require agreement among the non-market jurisdictions as to the sharing of the adjustments between the multiple residual income earners. The final Pillar I proposal, as further elaborated, will simply need to tackle that issue, or it will be left to the lengthy process of *ad hoc* resolution *via* competent authority proceedings (or worse—to double taxation).

Ultimately, as is the case with the affirmative implementation of Pillar I taxation in the United States, if double taxation is to be avoided under Pillar I, statutory changes will be needed to properly implement correlative relief in a manner that avoids double taxation without simply leaving taxpayers to the vicissitudes of the foreign tax credit system. Given the nature of Pillar I taxation, the conventional Transfer Pricing Approach to correlative relief may be both difficult to administer (one doesn't know the Amount A taxation allocable to a particular jurisdiction for a particular year until one's annual financial accounting is complete; so retroactive transfer pricing adjustments would almost always be necessary) and arguably inconsistent with Pillar I taxation more generally (in the sense that the tax does not purport to reflect the result of arm's-length dealing). And as discussed above, the Do Nothing Approach likely leads to effective double taxation in many circumstances. The Exemption Approach—while new to U.S. law—might be the most appropriate vehicle for mitigating double taxation in a post-Pillar I world.

More broadly, the increased likelihood post-Pillar I implementation of multi-party income reallocations requires either a treaty-based approach for handling such tri-partite disputes—either *via ex ante* rules regarding the sharing of Amount A reallocation within a corporate group, or through *ex post* multi-party competent authority procedures that can efficiently resolve multi-jurisdictional disputes regarding Amount A reallocations. This argues for either a "treat maximalist" approach to the design of, at least, multi-jurisdictional Amount A reallocation, or a more robust multi-jurisdiction adjudicative system for resolving these disputes. Under the former approach, domestic-law correlative relief would need to be designed to accommodate whatever Pillar I mechanism is adopted for the allocation of the Amount A adjustments; while under the latter approach, domestic law correlative relief would largely give way to multilateral mutual agreement procedures under existing (amended) treaties. In either event, the domestic design of correlative relief would in a significant manner need to be designed to accommodate the design of Pillar I taxation if such correlative relief is in fact going to mitigate double taxation in the inevitably increased number of multilateral Pillar I disputes.

VI. Conclusion

Pillar I taxation, if it is to be implemented, promises to fundamentally alter the landscape for the taxation of cross-border income by abandoning (in part) the core principles of separate entity accounting and arm's-length pricing. Since those principles underlie the central features of the tax treaty system as it relates to the taxation of cross-order business income, the tax treaty network itself will need to be significantly revised to accommodate Pillar I taxation. Those treaty provisions that today limit the taxation of non-residents' business income—the permanent establishment and associated enterprises provisions of Articles 5, 7, and 9 tax treaties—will need to be carved back to permit a new form of business income taxation. A gap is thus left in the treaty system, leaving open the question of who will be granted the authority to fill that gap.

Treaties themselves may be assigned that task, transforming treaties from largely "defensive" instruments (restricting the scope of non-resident taxation based on broad principles but not affirmatively imposing any detailed taxation regimes and largely leaving taxing jurisdictions to design their own systems for correlative relief to mitigate double taxation) into "offensive" instruments that themselves set forth the details of the new Pillar I tax regime and associated correlative relief (even if domestic implementing legislation is still needed). Alternatively, treaties may leave this gap (at least partially) unfilled, leaving it to domestic taxing authorities to determine the precise design of their Pillar I regimes, perhaps within certain broader parameters.

The path taken in designing and implementing such a Pillar I regime—whether the "treaty maximalist" or "treaty minimalist" approach discussed in this article, or some compromise thereof—will influence both *who* gets to design the Pillar I regime as well as the content of that regime itself. Given the nature of the tax treaty system, the simpler the Pillar I tax the more feasible it is for it to be implemented through the treaty network; and conversely, the more complex and nuanced the system, the more difficult the treaty implementation and the more likely that jurisdictional variability will result. Ultimately, in the case of Pillar I taxation, the questions of *who* gets to decide and *what* can plausibly be decided are inextricably linked, with the traditional concepts of tax sovereignty and the role tax treaties standing in the balance.

ENDNOTES

* This article is based on a panel discussion presented at the University of Chicago Law School's 72nd Annual Federal Tax Conference.

1 OECD, *Public Consultation Document, Secretariat Proposal for a "Unified Approach" Under Pillar One* (2019) (hereinafter Public Consultation Document).

2 OECD/G20 Base Erosion & Profit Shifting Project, Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report, (2015).

3 OECD, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (2019) (hereinafter Programme of Work).

4 *Id.* ¶ 23.

5 *Id.* ¶ 5.

6 Public Consultation Document, ¶¶ 7–8.

7 Programme of Work, §1.2.

8 *Id.*

9 *Id.*, at §1.3.

10 *Id.*, at §1.4.

11 Public Consultation Document, §2.1.

12 It is somewhat unclear from the Public Consultation Document whether the returns on functions other than "baseline marketing and distribution" are reflected in Amount B or Amount C. *Id.*, at ¶ 15.

13 *Id*.

14 *Id.* at note 6 ("The deemed residual profit used for Amount A would be the result of simplifying conventions agreed on a consensual basis.").

15 *Id.*, at ¶ 30.

16 *Id.*, at ¶ 20.

17 *Id.*, at note 7.

18 *Id*.

19 Reg. §1.954-3(a)(4).

20 PL. 115-97, 131 Stat. 2054 (2017).

21 Proposed Reg. §1.250(b)-4(d)(2)(iii).

22 Since the tax base for measuring Amount A is consolidated financial statement income, and since related-party royalties are effectively disregarded in financial consolidation, presumably related-party licensing arrangements are irrelevant in measuring and allocating a corporate group's Amount A.

23 Yet another set of questions arises if Amount A is to be measured by business segment. In that case, further adjustments may be necessary to measure business-segment-level operating profits to determine whether the relevant business line is earning residual profits. Rules will be required to determine the proper allocation of cross-segment expenses, such as headquarter-type expenses. Likewise, cross-segment transactions would need to be priced appropriately so as to avoid distortions of segment-level profitability.

24 There is, of course, wide variability today across jurisdictions regarding the restrictions on the use of carried-forward losses, both in terms of the period for carry-forward and limitations on use, whether as a general matter or as a result of specific transactions, such as change in control transactions or discontinuations of business lines.

25 Public Consultation Document, ¶ 30.

26 *See* Letter from Steven Mnuchin, Secretary of the Treasury of the United States, to Jose Angel Gurria, OECD Secretary-General (Dec. 3, 2019). ("For any new multilateral agreement to become effective, it will need to be implemented through amendments to tax treaties and/or through domestic legislation.").

27 *See* Code Secs. 864(b), 871(b), 882(a). *See also* Reg. §1.864-2(e); *Scottish American Investment Co.*, 12 TC 49, Dec. 16,773 (1949); *A.R.E. Pinchot*, CA-2, 40-2 USTC ¶9592, 113 F2d 718.

28 Code Sec. 482.

29 Reg. §1.482-1(a)(1), (b)(1). *See also Altera Corp.*, CA-9, 926 F3d 1061 (2019) ("The parties agree that, under the governing tax statute, the 'arm's length' standard applies.").

30 *See, e.g.*, OECD, Model Tax Convention on Income and Capital (2017) (hereinafter OECD Model Convention), Art. 5; United States Model Income Tax Convention (2016) (hereinafter U.S. Model Treaty), Art. 5.

31 *Id.*, at Art. 7.

32 *Id.*, at Art. 9.

33 Such adjustments are often implemented *via* the Mutual Agreement Procedures ("MAP") provided for in treaties to permit the competent authorities in the relevant jurisdictions to resolve disagreements between the jurisdictions regarding taxation of cross-border income so as to prevent the double taxation of that income. *See*, *e.g.*, OECD Model Convention, Art. 25; U.S. Model Treaty, Art. 25.

34 Public Consultation Document at ¶¶ 22, 27, 28.

35 *See*, *e.g.*, OECD Model Convention, Art. 3(2); U.S. Model Treaty, Art. 3(2); *see also* Rebecca M. Kyser, *Interpreting Tax Treaties*, 101 Iowa L. Rev. 1387 (2016).

36 *See* Rebecca M. Kysar, *On the Constitutionality of Tax Treaties*, 38 Yale J. Int'l Law 1 (2013).

37 *See* Curtis A. Bradley, *International Delegation, the Structural Constitution, and Non-Self Execution*, 55 Stanford L. Rev. 1557 (2003).

38 *See* OECD Model Convention, Arts. 23A, 23B (setting forth, in the alternative, the credit and

exemption methods for relief from double taxation); U.S. Model Treaty Art. 23 (setting forth the credit method for relief from double taxation, "[i]n accordance with the provisions and subject to the limitations of the law of the United States").

[39] Current U.S. law also provides for further adjustments in respect of the transfer pricing adjustment to align the reallocation of the income with the location of the corresponding cash within the multinational group's structure. *See* Rev. Proc. 99-32, 1999-2 CB 296. Those types of secondary adjustments will be discussed further below in the context of discussing the approaches to correlative relief for reallocation of Amount A income.

[40] *See also* Reg. §1.482-1(a)(3) (allowing taxpayers to make affirmative transfer pricing adjustments in certain circumstances).

[41] *See, e.g.*, U.S. Model Treaty, Art. 23.

[42] For a comprehensive discussion of the varieties of treaty resourcing provisions contained in (or absent from) U.S. tax treaties, *see* New York State Bar Association Tax Section, Report on Treaty Re-Sourcing Rules, November 24, 2014.

[43] *See* Public Consultation Document, §2.3.

[44] Code Sec. 960(d)(3).

[45] Code Sec. 904(c).

[46] *Id*.