A Pillar One Design Proposal: Leveraging Pillar Two

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Heydon Wardell-Burrus

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Heydon Wardell-Burrus*

1 Introduction

Despite the best attempts of a variety of officials, there appears to be pessimism in the tax community that Pillar One can be implemented. Much of this pessimism is driven by the belief that Pillar One cannot be implemented without the United States amending its tax treaties.[1] Under the US Constitution, a treaty cannot be ratified without a two-thirds majority in the Senate.[2] Accordingly, existing US tax treaties will not be amended without bipartisan support. Considering the degree of partisanship in the United States, and the expectation that this would involve granting foreign states the ability to increase taxation on US multinational enterprises (MNEs), commentators are asking whether Pillar One can be achieved at all.

It is somewhat less clear whether the Biden Administration itself thinks that Pillar One will require treaty ratification. In a Senate Hearing on 7 June 2022, Treasury Secretary Yellen said in response to a question on Congressional approval of Pillar One '…the ratification requires Congress's approval. There's no doubt about it, but the form that needs to take is to be determined'.[3] This language is consistent with a statement from Neil MacBride as part of his nomination proceedings for the position of Treasury general counsel, in which he suggested that Pillar One could be achieved by "a congressional executive agreement, or through legislation overriding the existing treaties".[4]

* Heydon Wardell-Burrus is completing his DPhil in Law at the University of Oxford and is a researcher at the Oxford Centre for Business Taxation. Before coming to Oxford, he worked for the Australian Taxation Office on Pillar Two and was a Senior Associate in the Tax Group at Allens Linklaters in Sydney, Australia. The author can be contacted for comments at Heydon.Wardell-Burrus@chch.ox.ac.uk.
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[1] See, for example, Herrington et al, The Diverging Paths of Pillars 1 and 2, *Tax Notes International,* 4 July 2022.
[2] US Constitution, Article II, Section 2.
[3] Treasury Secretary Yellen Testimony to the US Senate Finance Committee, 7 June 2022 (see https://www.c-span.org/video/?c5018385/user-clip-toomey-oecd-etc). While Secretary Yellen referred to the 'ratification process' requiring Senate approval (which would indicate a formal Senate ratification of a Treaty), her subsequent comment that '…the form that needs to take is to be determined' suggests that her earlier statement may not have referred to formal ratification but rather a vote of some form as of yet not determined.
[4] See Mindy Herzfeld, Can the United States Make Good on Its International Tax Commitments?, *Tax Notes International*, 15 November 2021.

It is not currently clear what the Biden Administration, or the Inclusive Framework, have in mind in terms of how to reallocate taxing rights towards the market jurisdiction. While the Inclusive Framework has released documents which address issues regarding identifying Amount A and allocating it to a market jurisdiction, no detail has yet been released on how the tax liability would be imposed and how double taxation would be avoided.

In this article, I put forward a proposal which is designed to have reasonable prospects of achieving bipartisan consensus in the United States that would allow for Senate ratification of treaty amendments. However, it is also designed so that the mechanism can operate *without* Senate ratification and could be successfully implemented by domestic legislation in the United States.[5] I do not purport to provide a complete solution to Pillar One but rather the rough contours of a design for two key issues which would need to be shaped into an acceptable solution by the Inclusive Framework. In doing so, I only seek to address design issues which arise from seeking to reallocate taxing rights once the amount and location of the reallocation has been determined. Accordingly, this paper assumes the resolution of a variety of important design questions for Pillar One which determine how much profit is to be allocated to which market jurisdiction.[6]

In a nutshell, the proposal leverages design elements of Pillar Two to (a) impose the required tax liability on the MNE and (b) identify an appropriate 'ceding' jurisdiction to avoid double taxation. The first objective is achieved by leveraging the Pillar Two infrastructure of a top-up tax to ensure that the MNE pays the required taxes to the market jurisdiction regardless of any applicable tax treaties. The second objective is achieved by creating an allocation mechanism to determine the ceding jurisdiction which relies upon the Pillar Two defined concepts of Excess Profits and Effective Tax Rate (ETR).

Ultimately, I argue that this design could be capable of bipartisan support in the United States. However, even if it is not, it is capable of implementation through US domestic legislation. Finally, the mechanism would even be capable of operating (albeit in a non-ideal fashion) on a temporary basis prior to the passing of US domestic legislation. These features make it an attractive option for consideration by the Inclusive Framework.

[5] For a broader analysis of how the US could seek to implement Pillar One without the Senate ratifying a treaty, see Mindy Herzfeld, Can the United States Make Good on Its International Tax Commitments?, *Tax Notes International*, 15 November 2021.
[6] These issues include scope, nexus, quantum, revenue sourcing, tax base determination and segmentation.

2 Pillar One – An outline

At a high level, Pillar One seeks to grant market jurisdictions taxing rights to a portion of the profits of the world's largest and most profitable MNEs. The agreed contours of its design were released on 8 October 2021.[7] The regime is to apply to MNEs with global turnover of above 20 billion euros (falling to 10 billion euros) and profitability above 10% where profitability is defined as 'profit before tax / revenue'. Extractives and regulated financial services are to be excluded.

For in-scope entities, there will be a reallocation of 25% of residual profit (defined as profit in excess of 10% of revenue) to market jurisdictions. This is 'Amount A'. Revenue sourcing rules will be determined to allocate Amount A to each market jurisdiction. The rules will rely upon financial accounting (rather than a domestic tax base) and segmentation of businesses is only to occur in exceptional circumstances.

An important element of the design is the 'marketing and distribution safe harbor'. The concept is that where residual profits are already being taxed in the market jurisdiction, the Amount A allocation will be reduced (potentially to zero) in order to avoid a 'double allocation' to the market jurisdiction.

The rules will also require the relief of double taxation by the entity or entities earning the residual profit either by a credit or exemption method. Dispute prevention and resolution mechanisms will be built into the design to ensure tax certainty for in-scope entities. This mechanism will extend to 'all issues related to Amount A (e.g. transfer pricing and business profits disputes), in a mandatory and binding manner'.

There are other elements of Pillar One such as Amount B and the requirement to remove 'unilateral measures'. However, these are beyond the scope of this working paper.

3 The Proposal

Pillar Two concepts can be leveraged to (a) ensure that the market jurisdiction receives the tax payments referable to their Amount A allocation and (b) identify an appropriate ceding jurisdiction to relieve double taxation. As noted above, the starting point is that an agreed 'Amount A' has been identified and allocated to each market jurisdiction.

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[7] OECD/G20 Inclusive Framework, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 8 October 2021, (8 October Statement).

It is important to recall that Amount A is an allocation of *profit* to a market jurisdiction. It is not an amount of tax. It will be for the market jurisdiction to determine the tax rate which will be imposed on the Amount A profit allocation for their jurisdiction. I will refer to the allocation of profit as Amount A and any accompanying tax liability as an 'Amount A Tax Liability'.[8]

The proposal effectively separates two key elements which usually go together under the existing international tax system. This design focuses on achieving the right outcomes and then building a working mechanism that operates within existing rules and law to achieve that outcome. The two key elements are that there must be (a) a payment of the relevant tax liability and (b) there must be a 'ceding jurisdiction' which currently has taxing rights which is required to prevent double taxation on the MNE. Crucially, the paying entity does not need to be in the ceding jurisdiction.

3.1 Imposing the Amount A Tax Liability

The first step is to ensure that the market jurisdiction receives a tax payment for the relevant Amount A Tax Liability (that is, the market jurisdiction's Amount A allocation multiplied by the applicable tax rate). This outcome is achieved by leveraging Pillar Two's top-up tax mechanism to ensure that the MNE is appropriately incentivised to make the payment. As the ceding jurisdiction is determined separately (see below), the proposal allows for any entity in the MNE group to make the actual tax payment. This may be helpful as a matter of simplification if the MNE wishes to pay all Amount A liabilities from a single entity.

In the context of Pillar One, it is important that a country can receive an Amount A allocation even without a resident entity or permanent establishment of the MNE. This is to ensure that the reallocation of taxing rights to the market jurisdiction cannot be avoided simply by not having a resident entity or permanent establishment in the jurisdiction. Accordingly, the payment infrastructure cannot rely upon the market jurisdiction imposing tax on a resident entity. The Pillar Two infrastructure can be leveraged to produce this outcome by relying upon conditional taxes which will apply if the Amount A Tax Liability is not paid to the market jurisdiction.

[8] It is not currently clear how market states would impose taxes on their Amount A allocations and, in particular, whether states would be allowed or incentivised to impose higher tax rates than are generally applicable to corporate profits made within their jurisdiction. In any event, a higher tax rate on a state's Amount A allocation does effectively increase the tax on the profits from sales to the jurisdiction and MNEs could alter their prices in response to different tax rates on Amount A. Accordingly, it should not be assumed that market states will have an incentive to impose 100% tax rates on their Amount A allocation.

Pillar Two relies upon the Income Inclusion Rule (IIR) and Undertaxed Profits Rule (UTPR) to operate as 'back-up taxes'. If the minimum tax is not paid to the source country, a tax liability will be imposed either under the IIR or UTPR. This design motivates MNEs to pay the minimum rate of tax. The theory behind the IIR and UTPR is not that the jurisdictions imposing the IIR or UTPR *ought* (from a policy perspective) to be collecting the relevant revenue but rather that it is administratively simplest to impose taxes in these jurisdictions to ensure that the minimum tax is paid. That is, the IIR and UTPR create an incentive for the minimum level of tax to be paid in the relevant source jurisdiction. If all source countries collect the minimum level of tax, there will be no IIR or UTPR.

This same design can be utilised to ensure that any Amount A Tax Liability is paid to the market jurisdiction. Under Pillar One, an Amount A Tax Liability would be owed to a particular market jurisdiction. This amount could be added to the jurisdictional top-up taxes due under the IIR (and failing the IIR, the UTPR). However, a full credit would be made available for any Amount A Tax Liability payment made by any entity of the MNE to the relevant market jurisdiction. The result is to create an incentive for the MNE to pay the required amount to the market jurisdiction. As long any entity in the MNE group paid the Amount A Tax Liability to the correct market jurisdiction there would be no additional tax under the IIR or UTPR.

There is an important difference between the Pillar Two design and the way in which it would need to operate to support Pillar One. The Pillar Two mechanism makes the MNE ***indifferent*** as to whether it pays the minimum tax to the source jurisdiction or under the IIR. It incentivises the source country to collect the minimum amount of tax because if it does not, that additional amount of tax will be imposed on the MNE in any event. In other words, the source country does not make the MNE any better off by failing to collect the minimum tax. As a result, the source country is simply 'giving away revenue' if it fails to collect the minimum amount. However, under this design, the MNE itself may have no preference for paying the jurisdictional minimum tax to the source state over the IIR.

In the context of Pillar One, however, it is important to ensure that the tax is paid to the correct jurisdiction (the market jurisdiction). This paper considers two potential options for addressing this problem. Under Option 1 (the financial indifference model), the rules do not create a financial incentive for the MNE to pay the market jurisdiction over the IIR jurisdiction. The MNE would simply be *financially* indifferent to where it paid the tax and therefore might as well pay the relevant market jurisdiction. While this option does not rely on a financial incentive to pay the market jurisdiction, other incentives besides the amount of actual tax paid could be utilized to ensure that the MNE pays the correct jurisdiction. For example, the

MNE's access to the tax certainty process (which is likely to be very valuable to the MNE) could be made contingent upon the MNE paying the market jurisdictions (and not simply paying the required amount under the IIR). Under Option 2 (the financial incentive model), a financial incentive is built into the top-up tax liability to motivate the MNE to pay the tax to the market jurisdiction and not the IIR jurisdiction. This financial incentive should be set at the minimum level required to ensure the market jurisdiction is paid.

Option 1 – Financial indifference model

Under Option 1, the MNE is effectively left indifferent from a purely financial perspective as to whether it pays the top-up tax to the market jurisdiction or not. This could be achieved by adopting the following addition to the jurisdictional top-up tax (which would be payable under the IIR or UTPR):

$$Jurisdictional\ Amount\ A\ Top-up\ Tax =$$

$$(Amount\ A * Jurisdictional\ Tax\ Rate) - \ Amount\ A\ Tax\ Liability\ Payments$$

Where:

'*Jurisdictional Amount A Top-up Tax*' is the amount added to the 'Jurisdictional Top-up Tax' under Pillar Two and subject to the IIR or UTPR

'*Amount A*' is the Amount A allocation to the market jurisdiction

'*Jurisdictional Tax Rate*' is the tax rate which is applied in the market jurisdiction to the Amount A allocation

'*Amount A Tax Liability Payments*' are payments from <u>*any*</u> entity of the MNE group to the market jurisdiction for the Amount A Tax Liability

'*Amount A Tax Liability*' is the tax liability for the jurisdiction which arises from the Amount A allocation (that is, the Amount A allocation multiplied by the Jurisdictional Tax Rate)

Under this design, the *potential* top-up tax will simply be what the Amount A Tax Liability in the market jurisdiction. From the MNE's financial perspective, it does not matter which jurisdiction is paid – the liability is the same. The result of this mechanism is that the MNE is financially indifferent in whether it pays the market jurisdiction or the IIR jurisdiction. However, the prevalence of other features of the Pillar One design may adequately motivate the MNE to pay the market jurisdiction. A key candidate would be to prevent MNEs which do not pay the market jurisdiction from having access to the Pillar One tax certainty process. This would mean that, from the MNE's perspective, paying the IIR jurisdiction could

lead to a large downside risk of overlapping tax claims which are expected to be resolved through the tax certainty process. Finally, in this context, it is important to recall that we are only considering about 100 very large multinationals with sophisticated relationships with large tax authorities. These entities may be unlikely to adopt aggressive positions which subvert the result of Pillar One in a context where there is no (or limited) financial incentive to do so.

Option 2 – Financial incentive model

The second option would be to build into the design of the rules a financial incentive for the MNE to pay the market jurisdiction. The aim here is not to be punitive but simply to provide the most modest possible incentive required to ensure that the correct jurisdiction receives the funds. Importantly, no MNE will ever be required to pay the additional amount (created by the incentive) so long as it pays the market jurisdiction and not the IIR jurisdiction. This will entirely be within the control of the MNE.

While such a financial incentive could be provided in a variety of ways, one option is an 'uplift factor' which effectively creates a larger tax payment if the MNE does not pay the market jurisdiction as required but pays the IIR or UTPR jurisdiction. A technical mechanism for achieving this result is outlined below.

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = ((Amount\ A * Jurisdictional\ Tax\ Rate) - Amount\ A\ Tax\ Liability\ Payments) * Uplift\ Factor$$

'*Jurisdictional Amount A Top-up Tax*' is the amount added to the 'Jurisdictional Top-up Tax' under Pillar Two and subject to the IIR or UTPR

'*Amount A*' is the Amount A allocation to the market jurisdiction

'*Jurisdictional Tax Rate*' is the tax rate which is applied in the market jurisdiction to the Amount A allocation

'*Amount A Tax Liability Payments*' are payments from *any* entity of the MNE group to the market jurisdiction for the Amount A Tax Liability

'*Uplift Factor'* is the chosen incentive to encourage the MNE to pay the correct jurisdiction the top-up tax – for instance 1.1 would produce a 10% additional tax burden

This design would mean that there would be a financial incentive for the MNE to pay the market jurisdiction over the IIR or UTPR jurisdiction(s). The aim is to provide a sufficient incentive to pay the

correct jurisdiction but without adopting a punitive scheme. The 'uplift factor' would be set at the minimum possible rate to ensure that the right jurisdiction is paid. A simple example is set out below using 10% for illustrative purposes only. This ought not be interpreted as a recommendation for 10% as the appropriate amount.

An MNE has an Amount A allocation to State X of $100. State X has a Jurisdictional Tax Rate of 25% and, accordingly, the MNE has a $25 Amount A Tax Liability for State X. The uplift factor is 1.1 (10%).

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = ((\$100 * 25\%) - \ Amount\ A\ Tax\ Liability\ Payments) * 1.1$$

If the MNE pays the Amount A Tax Liability of $25 (as it is expected to do), there will be no Jurisdictional Amount A Top-up Tax.

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = ((\$100 * 25\%) - \$25) * 1.1$$

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = \big((\$25) - \$25\big) * 1.1$$

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = \$0$$

If the MNE makes no Amount A Tax Liability Payments (that is, it does not pay the market jurisdiction), there will be a Jurisdictional Amount A Top-up Tax of $27.50.

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = ((\$100 * 25\%) - \$0) * 1.1$$

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = \big((\$25) - \$0\big) * 1.1$$

$$Jurisdictional\ Amount\ A\ Top-up\ Tax = \$27.50$$

This mechanism creates an easy choice for the MNE. It can either pay its Amount A Tax Liability to the correct market jurisdiction ($25) or it can pay $27.50 under to the IIR or UTPR jurisdiction(s). The additional 10% tax payment is not designed to be collected; it is simply providing an incentive to ensure that the market jurisdiction receives the revenue.

If it were considered politically problematic to adopt this structure because the uplift factor was considered a 'penalty', alternative mechanisms could be adopted to provide the required financial incentive. For instance, the market jurisdiction could collect the Amount A Tax Liability without applying an interest charge while the Jurisdictional Amount A Top-up Tax imposed an additional interest charge between the end of the year and the payment of the tax. Alternately, the formula could be amended such

that there was a 'discount' for paying in the market jurisdiction. These design variations would all amount to a similar outcome of providing an incentive for the MNE to pay the market jurisdiction.

Allowing for losses in market jurisdiction

The above designs will work if the Amount A Tax Liability will be imposed by the market jurisdiction regardless of the tax position of any entities within the jurisdiction. However, the outlined designs do not account for cases where the market state wishes to allow the MNE to offset tax losses or credits of domestic entities against the Amount A Tax Liability. This outcome can be achieved by a simple modification to the relevant mechanisms by subtracting from Amount A, the amount of any 'Amount A Domestic Inclusion' and ensuring that there is no double counting between the domestic inclusion and Amount A Tax Liability Payments.

This is demonstrated under Option 1 (the financial indifference model) below:

$$Jurisdictional\ Amount\ A\ Top-up\ Tax =$$

$$((Amount\ A - Amount\ A\ Domestic\ Inclusion) * Jurisdictional\ Tax\ Rate) - Amount\ A\ Tax\ Liability\ Payments$$

Where the Option 1 definitions above are modified as follows:

> 'Amount A Domestic Inclusion' is the amount of Amount A which was included in the taxable income of a domestic entity subject to tax in the relevant market jurisdiction.
>
> 'Amount A Tax Liability Payments' are payments from ***any*** entity of the MNE group to the market jurisdiction for the Amount A Tax Liability but do not include any tax liability arising from an Amount A Domestic Inclusion.

This design would give market jurisdictions the choice as to whether or not the Amount A allocation should be capable of being offset against domestic losses or other domestic tax features.

Summary

By leveraging the Pillar Two top-up tax infrastructure, the MNE can be motivated to pay the relevant Amount A Tax Liability even if it does not have a taxable presence in the relevant jurisdiction. This section has set out two options regarding how to approach that mechanism. The key factor is providing an incentive for the MNE to pay the correct jurisdiction without being needlessly punitive or having

intergovernmental transfers.[9] Option 1 ensures that the MNE pays the same tax liability whether or not it pays the market jurisdiction. It would rely upon factors other than the tax liability to incentivise the MNE to pay the correct jurisdiction. A potential mechanism to create this non-financial incentive would be to limit access to the tax certainty process unless the MNE paid the market jurisdictions. Option 2 provides a financial incentive for the MNE to pay the correct jurisdiction. This incentive could be introduced by an 'uplift factor' or, (if an uplift factor is considered punitive) through other means such as a different interest charges or a discount for payments to the market jurisdiction. In choosing between options, the aim is to impose the minimum level of incentive required to ensure the correct jurisdiction is paid.

Importantly, this rule does not specify which entity in the MNE group must actually make the payment. From the perspective of the proposed design, it does not matter. The avoidance of double taxation is to be addressed through the identification of the ceding jurisdiction (addressed below). It could be generally up to the MNE to determine which entity in the group would make the payment (and they could, of course, choose the ceding jurisdiction). However, double taxation is to be relieved by the ceding jurisdiction and not by the paying entity. Accordingly, jurisdictions should not provide a tax benefit to an entity merely because it makes the payment (that is, no tax credit or deduction should be available to paying entities). If a tax benefit were given to the paying jurisdiction, this would be giving the MNE a double tax benefit. However, it would be solely at the expense of the revenue of the jurisdiction which (needlessly) gave that benefit.

It is also important to recall that this top-up tax mechanism cannot be avoided by simply not having the Ultimate Parent Entity (UPE) of the group in a jurisdiction which has implemented a qualified IIR. Pillar Two has been designed so that even if the entity is not headquartered in an IIR jurisdiction, the minimum tax must be paid because otherwise the UTPR will apply. Similarly, if an MNE is not subject to the IIR it will still be incentivised to pay all of its Amount A Tax Liabilities because otherwise the UTPR will apply to collect the Amount A Tax Liabilities.

3.2 Receiving the tax payment

The previous section outlined a mechanism to properly incentivise the MNE to pay the Amount A Tax Liability to the market jurisdiction. However, appropriate legal infrastructure would need to be in place in

[9] An alternative design would have allowed for an intergovernmental transfer between the IIR jurisdiction and the market jurisdiction. However, this possibility has not been explored on the basis that countries are currently unlikely to agree to a regime involving intergovernmental transfers. If this were not considered an obstacle, the IIR jurisdiction could collect the relevant payments and distribute to the market jurisdictions.

the market jurisdiction to ensure that it could receive the payment as a payment of tax. The mechanism outlined above does not impose an actual tax liability on any particular entity to pay the market jurisdiction. Accordingly, if the revenue authority of the market jurisdiction were to receive such a payment, upon what basis could it be accepted as a payment of tax?

There are again several options. One design approach in responding this challenge is to simply leave the issue to the relevant market state to resolve. The legal regimes against which this issue could arise may differ widely between countries with different administrative (and potentially constitutional) legal systems. If unique solutions are required for particular states, those outcomes should be accommodated (subject to ensuring the smooth functioning of the regime). While a full resolution of these issues is beyond the scope of this paper, several potential approaches are considered briefly.

The first option would be to impose joint and several liability on the MNE group as a whole. This would be consistent with the general approach of the design that it does not matter which specific entity makes the payment. It is worth noting that there is an interesting issue as to whether a liability can be imposed upon an entity without a 'taxable presence' in the jurisdiction consistently with the public international law requirements of jurisdiction to tax. While this question is beyond the scope of this article, for present purposes it is sufficient to note that it is an issue which is likely to confront any Pillar One design which allows for the imposition of tax in the market jurisdiction without a resident entity or permanent establishment. The design of Pillar One seeks to allocate part of the profits of an MNE group as a whole to each market jurisdiction. If this allocation is considered invalid under public international law, any Pillar One design which attempts this outcome is likely to be incompatible with international law.[10]

If a country was unable to adopt the first option for domestic law reasons, it could seek to impose the tax liability on the ultimate parent entity of the group. This is the entity that would generally be liable for the additional IIR top-up tax under the mechanism outlined above if the relevant Amount A Tax Liability payments were not made. The logic driving this approach would be that if not all entities in the group can be made subject to the liability for domestic law reasons, there may be a closer connection to the ultimate parent entity. Pillar One attributes a portion of the profits of the group to the market jurisdiction. These profits are indirectly the profits of the ultimate parent entity (following the logic by which controlled

[10] The author notes that there may be an argument that there is a distinction between Pillar One designs which attempt to 'trace' profit from the market jurisdiction to where they are currently booked and designs which rely upon a mechanical allocation without tracing (such as this proposal). If the former meet the public international law requirements of jurisdiction to tax while the latter do not, mechanical allocation rules may be limited.

foreign corporation rules can attribute the income of subsidiaries to parent entities). If the domestic and public international law requirements of imposing tax liabilities could not extend to the entire group, they could plausibly extend to the ultimate parent entity of the group.

In this context, it is worth noting that even if treaty protection were available to the MNE from the paying jurisdiction, it could be unwise for the MNE to rely upon that protection. While the MNE could claim treaty protection with respect to the immediate tax liability from the market jurisdiction, this would only trigger the top-up tax liability mechanism outlined above. Accordingly, even if treaty relief were available for the paying entity, the MNE would not be incentivised to rely upon it. This mechanism allows for the proposal to be adopted without requiring treaty amendment.

The proposal ensures that (a) the MNE is incentivised to make the Amount A Tax Liability payments and (b) that the relevant market jurisdiction is entitled to collect the relevant revenue as a tax. These mechanisms are not designed to determine which entity ought to give up taxing rights. That function is performed by the 'ceding jurisdiction' mechanism. However, it is important to ensure that the MNE does not get a 'double-benefit' under which there is reduced taxation both for the paying entity and for the ceding jurisdiction. In order to prevent this outcome, the paying entity should not receive a deduction or a tax credit for the relevant payment. Double-tax is avoided for the MNE separately and, as the jurisdiction of the paying entity is generally arbitrary under this design, there is no reason for the jurisdiction of the paying entity to cede any taxing rights which would be the outcome of granting a deduction or tax credit for the payment.

3.3 Identifying the ceding jurisdiction

The second key problem to resolve is how to avoid double taxation. Put differently, the rules need to identify a 'ceding jurisdiction' which will give up the taxing rights which have been reallocated to the market jurisdiction. The Amount A allocation has to come from somewhere – a jurisdiction needs to cede taxing rights over the profit allocated to the market jurisdictions under Pillar One. This proposal provides a mechanism for identifying the ceding jurisdiction or jurisdictions which leverages Pillar Two concepts in order to achieve an acceptable outcome that will avoid double taxation if universally adopted, and is likely to avoid double taxation even if not universally adopted.

The proposal is that a 'waterfall' mechanism be adopted whereby the ceding jurisdiction is identified as the jurisdiction with 'Excess Profit' with the lowest effective tax rate ('ETR'). Both of these concepts are defined in Pillar Two and can be utilised to create an allocation mechanism to determine which

jurisdiction(s) are required to cede taxing rights. However, before stepping through the detail, it is worth briefly sketching out the rationale.

The general theory is that a significant portion of MNE's residual profits are mobile. MNEs are capable of locating this residual profit in low tax jurisdictions and they are economically incentivised to do so. As a matter of fact, where MNEs have mobile residual profits they tend to locate those profits in low tax jurisdictions. Furthermore, there is no strong, normative sense in which we can say that the full value of what is booked in low tax jurisdictions has been 'created' there.[11] Pillar One can fairly take into account the way in which MNEs structure their operations by shifting residual profits to low tax jurisdictions. Pillar One seeks to reallocate a portion of residual profits to market jurisdictions. When we consider from where these residual profits ought to be taken, it is reasonable to select the jurisdictions where the MNEs currently have Excess Profits subject to the lowest tax rates.

In this context, it is important to recall the difference between 'residual profit' under Pillar One and 'Excess Profit' under Pillar Two. Under Pillar One, 25% of the profit (before tax) greater than 10% of revenue is reallocated to market jurisdictions. The concept of 'profit greater than 10% of revenue' is what is meant by 'residual profit'. It is determined by financial accounts of the entire MNE group and is not calculated by reference to any particular jurisdiction. 'Excess Profit' is a Pillar Two concept and is calculated on a jurisdictional basis. Excess Profit is the total profit of the jurisdiction less any 'substance-based income exclusion' (SBIE). SBIE is a formulaic mark-up on the eligible payroll expenditure and carrying value of eligible tangible assets in the jurisdiction.[12] The idea is that eligible payroll and tangible assets reflect 'substance' in the jurisdiction. Accordingly, Excess Profits are those that exceed a formulaic return on the substance in the jurisdiction.

At a high level, the ETR of a jurisdiction is calculated by dividing 'Adjusted Covered Taxes' (generally taxes on profit) by the Adjusted GloBE Income in the jurisdiction.[13] The ETR calculation is central to Pillar Two as a key input in determining the minimum amount of tax which must be paid. Pillar Two operates to

[11] See further literature on value creation - Michael Devereux and John Vella, 'Value Creation as the Fundamental Principle of the International Corporate Tax System', *European Tax Policy Forum*, 31 July 2018; Michael P. Devereux and John Vella, 'Are we heading towards a corporate tax system fit for the 21st century?' (2014) *Fiscal Studies*, Vol 35. No. 4, 449; see, in particular, pages 463-468; Michael Devereux and John Vella, "Taxing the Digital Economy: Targeted or System-Wide Reform", British Tax Review 2018, Vol 4., 387. On value creation see also the contributions in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation*, IBFD, 2021.
[12] See Art. 5.3 of the GloBE Model Rules.
[13] The formula is more complicated than simply Covered Taxes divided by financial accounting income. See Arts. 3 and 4 of the GloBE Model Rules for further detail.

impose a top-up tax which is equal to the difference between the 15% and the ETR, multiplied by the amount of Excess Profit. All MNEs which are in-scope for Pillar One will already be required to calculate their ETR and Excess Profit for each jurisdiction under Pillar Two.[14]

The proposal leverages these Pillar Two concepts for Pillar One, by creating an allocation mechanism for ceding jurisdictions. Once the total Amount A allocations are determined for each market jurisdiction, a ceding jurisdiction must be found for an equal amount of profit. Under this proposal, the jurisdiction with the lowest ETR (as determined under Pillar Two) will cede the total amount of its Excess Profit or the total sum of Amount A reallocations (whichever is less). If the former (that is, if the total amount of Excess Profit is ceded), the jurisdiction with Excess Profit and the 2nd lowest ETR will be subject to the same process. The waterfall will continue until the total Amount A allocation has been ceded.

This is best demonstrated through an example.

An MNE has $400m of residual profits. Under Pillar One, 25% of those profits are to be allocated to market jurisdictions. Five separate market jurisdictions are each entitled to an Amount A allocation of $20m. Accordingly, the total sum of Amount A allocations is $100m. The MNE group has a taxable presence in only four countries (A-D) (that is, it books all of its profits in these four jurisdictions under transfer pricing principles). The profit, Excess Profit and Effective Tax Rates (ETRs) of each of those jurisdictions are listed below in the table below (ordered by ETR).

An allocation is only made to a country to the extent of its Excess Profits.

Production Jurisdiction	**Total Profit**	**Excess Profit**	**ETR**	**Allocation**
Country A	$60m	$0	0%	-
Country B	$55m	$50m	4%	$50m
Country C	$50m	$10m	6%	$10m
Country D	$350m	$340m	10%	$40m
			Total	$100m

*Note – the residual profits need not match the Excess Profits.

While Country A has the lowest ETR, it has no Excess Profits. Accordingly, it is not a ceding jurisdiction at all. Country B has the second lowest ETR and has Excess Profits. While it has total profits of $55m, an

[14] This is subject to two caveats – first, where a simplification mechanism is in place so that a top-up tax calculation is not required, and second, where the ETR is above 15% (and therefore there can be no top-up tax) it could be unnecessary to calculate the Excess Profit. Neither is likely to apply to the lowest tax jurisdictions with Excess Profit in the group.

allocation is only made to the extent of its Excess Profits – accordingly, only $50m of allocation is made. The same applies to Country C up to its cap of $10m. Finally, an allocation is made to Country D for the remaining $40m.

The allocation operates as a waterfall. The result will be that the ceding jurisdiction will be that with the lowest ETR and with Excess Profits. However, the mechanism will never reduce the taxing rights of a jurisdiction below their amount of Excess Profits. If the MNE has shifted at least 25% of its Excess Profits into the lowest tax jurisdiction with Excess Profits, then the Amount A allocation will entirely come from shifted income.

It should be noted that the above example is designed to set out how the rules operate rather than to reflect a likely scenario. In practice, it seems more likely that the MNE would be booking more of its Excess Profits in a lower tax jurisdiction. The Appendix considers a further example with Excess Profit concentrated in a group IP Co and Finance Co.

Potential Modifications

The above section has set out the starting point for a rule design. However, two important variations ought to be considered as they are likely to increase support for the proposed model. First, a *de minimis* threshold could be adopted to reduce complexity and to ensure that the ceding jurisdiction had a reasonable portion of the Excess Profit of the MNE group. Second, a mechanism could be adopted to ensure that the ceding jurisdiction retained taxing rights over a portion of the Excess Profits. This may be important to gain the support of certain low tax states as part of the Inclusive Framework.

A *de minimis* threshold is an appropriate modification of the rules to prevent the design identifying too many ceding jurisdictions with limited Excess Profits. The waterfall allocation rule may be unnecessarily complicated if there are multiple low tax jurisdictions with small amounts of Excess Profits. Accordingly, a rule could be adopted that a jurisdiction would not be identified as a ceding jurisdiction unless it booked at least a certain percentage (for example, 10%) of the MNE group's total Excess Profit.[15] This is likely to limit the number of ceding jurisdictions which would arise.

The second variation would be to allow the ceding jurisdiction to retain taxing rights over a portion of their Excess Profits *even if their Excess Profit would all have been allocated under the primary rule.* This

[15] Alternately, those jurisdictions with below the de minimis threshold of Excess Profit could simply be pushed to the bottom of the waterfall.

variation would be designed to encourage support by Inclusive Framework members that have Excess Profits and low tax rates. A simple model would be to cap the allocation as a ceding jurisdiction to a certain percentage (for example, 80%) of the Excess Profits. This would ensure that the ceding jurisdiction would retain taxing rights over at least 20% of their Excess Profits. This design would advantage low tax jurisdictions with Excess Profits regardless of the amount of substance in their jurisdiction. If the design wanted to benefit only those with real substance, an increased profit exclusion could be calculated by reference to the amount of SBIE in the jurisdiction.

In this context it is important to note that only 25% of residual profits are being reallocated under Amount A. If a significant portion of these profits are booked in a single low tax jurisdiction, these limitation rules are unlikely to have any effect. However, such variations could potentially be necessary to gain the support of the Inclusive Framework. In negotiating such extended carve-outs, a trade-off will necessarily be involved. As the carve-outs expand, there is an increased likelihood that higher tax jurisdictions will be called upon to relieve double taxation.

3.4 Relieving double taxation

Once a jurisdiction has been identified as the ceding jurisdiction, it is expected under the Pillar One design that it will relieve any double taxation. The 8 October Statement explicitly allows for either a credit or exemption method to be adopted to avoid double taxation. Under the exemption method, the Amount A ceded by the relevant jurisdiction is exempt from taxation. However, there would still be issues of determining which income within the jurisdiction (recall there may be multiple entities) is to be exempt from taxation. This is not necessarily simple as there may be sources of income in the jurisdiction which are subject to different tax rates or other limitations. Within the general constraints of providing double taxation relief, it could be left up to the ceding jurisdiction how to allocate the exempt income within its jurisdiction.

The alternative mechanism would be to adopt the credit approach. Under the credit approach, the relevant income would remain in the tax base of the ceding jurisdiction but a credit would be granted for taxes paid on that income. The challenge is that different market jurisdictions may impose different tax rates on the relevant income and there is no way in which ceded profits are traced through to a particular market jurisdiction. In the absence of such tracing, a simple apportionment rule is appropriate. This would involve creating a set of Amount A Tax Credits (taxes paid on reallocated Amount A across all jurisdictions). Having determined this total pool, the credits would be provided proportionately to each ceding

jurisdiction in proportion to the amount they had ceded. This mechanism works where some countries have adopted the credit method and other countries have adopted the exemption method.

This example continues from the above. There are 5 market jurisdictions each entitled to a $20m allocation – Countries 1-5. There are 4 countries with a taxable presence (Countries A-D). Countries 1-5 receive an Amount A allocation and impose different tax amounts (see table below).

Market Jurisdiction	**Amount A**	**Tax Rate**	**Amount A Tax**
Country 1	$20m	5%	$1m
Country 2	$20m	10%	$2m
Country 3	$20m	15%	$3m
Country 4	$20m	20%	$4m
Country 5	$20m	25%	$5m
		Total	**$15m**

Countries A-D (the ‘production’ jurisdictions with a taxable presence) receive their allocations as ceding jurisdictions as outlined in the above section (reproduced in the table below). In terms of method to relieve double taxation, Countries A and B have adopted the exemption method while Countries C and D adopt the credit method. The allocation of tax credits under the credit method are in the table below.

Production Jurisdiction	**Excess Profit**	**ETR**	**Amount A Allocation**	**Amount A Tax Credits**
Country A	$0	0%	-	N/A
Country B	$50m	4%	$50m	N/A
Country C	$10m	6%	$10m	$1.5m (15m * 10/100)
Country D	$340m	10%	$40m	$6m ($15m * 40/100)
		Total	$100m	

In this case, Countries A and B have adopted the exemption method. For Country A, this is irrelevant as it has not received an Amount A ceding allocation. Country B has received such an allocation – its domestic taxable income is reduced by $50m (the amount allocated under the rule).

Countries C and D have adopted the credit approach. Accordingly, there is no reduction in the domestic tax base. However, each jurisdiction is entitled to a proportionate share of Amount A Tax Credits. There are total tax credits of $15m on the $100m of Amount A allocated to Countries 1-5. As Country C has ceded $10m of $100m in total Amount A allocation, 10% of the available tax credits are allocated to Country C (i.e. there are tax credits of $1.5m). Country D has ceded $40m of $100m in total Amount A allocation and would therefore have $6m in Amount A Tax Credits to include under the credit method.

It would be a matter for Country C and Country D to determine whether there ought to be a cap on the use of those tax credits under their domestic law. For example, they could decide that such tax credits would not be available for use beyond the tax liability on the ceded profits under the domestic tax system. These countries would also need to determine how to make the credits available to the MNE operating in the jurisdiction (again noting that there may be multiple entities with different tax characteristics).

3.5 Non-participating jurisdictions

The important fact here is that it is the responsibility of the identified ceding jurisdiction to relieve the double taxation under the credit or exemption method. This leads to the obvious question – what happens if the relevant ceding jurisdiction does not agree to (or implement) Pillar One? The simple answer is that there will be unrelieved double taxation. However, there are good reasons why the proposed design (a) minimises the likelihood of that outcome happening and (b) limits the consequences of the cases where it does occur.

The key element is that the ceding jurisdiction is the lowest tax jurisdiction in the group with Excess Profits. By starting the allocation with the lowest taxed entity with Excess Profits, we are identifying a ceding jurisdiction that is not only likely to be where the MNE would intentionally shift residual profit but also a jurisdiction which is likely to grant relief from double taxation. Any state which has pursued a low taxation strategy in order to attract Excess Profit is unlikely to deliberately impose double tax on MNEs operating within their jurisdiction. Furthermore, it is unlikely MNEs would tolerate such an outcome for long. If an MNE were booking its Excess Profits in a low tax jurisdiction that refused to grant relief from double taxation, we would expect the MNE to consider relocating that Excess Profit away from the jurisdiction imposing double taxation. Accordingly, it is unlikely that there would be significant unrelieved double taxation.

To the extent that there is unrelieved double taxation, the consequences will be minimised because the double taxation will be imposed at the lowest tax rate of any of the Excess Profit in the group. The proposed identification mechanism therefore not only identifies the jurisdictions which are most likely to grant relief from double taxation but also the jurisdictions where double taxation would (if imposed) have the smallest impact on the MNE.

The result is that the ceding jurisdictions are unlikely to deliberately impose double taxation and, even if they do, it creates a system which imposes the least harmful double taxation. In this context it is important to recall that there may be significant benefits provided to participating jurisdictions which would also

encourage them to join the agreement. Two key features are the fact that the jurisdiction will only be entitled to an Amount A allocation if it joins the agreement and that jurisdictions' involvement in the relevant tax certainty process could be made conditional on joining the agreement.

3.6 Interactions with Pillar Two

There are important interactions between this Pillar One proposal and Pillar Two. It has been announced that Pillar Two would operate on a post-Pillar One basis. Accordingly, any reallocations under Pillar One need be taken into account in determining the relevant ETR calculation under Pillar Two. As this proposal already relies upon an ETR calculation, there is a risk of circularity. The proposed solution would rely upon a two-step Pillar Two calculation.

First, the ETR would be calculated without taking into account Pillar One at all. These ETR calculations would provide the basis for the Pillar One allocation calculations to determine the ceding jurisdictions outlined above. Once the Pillar One calculation was determined under this proposal, the Pillar Two calculation would be recalculated with the relevant adjustments. The Amount A reallocations would be added to Adjusted GloBE Income for the Pillar Two calculation (the denominator of the ETR calculation). Any Amount A Tax Liability payment could be added to adjusted Covered Taxes (the numerator of the ETR calculation).

While this two-step calculation would add complexity to Pillar Two, it is unlikely to be a significant additional burden in the context of Pillar Two's current design. The complexity of this step is not large compared to the variety of other adjustments required under the Pillar Two calculation. In any event, it is crucial that this would only apply to the approximately 100 largest and most profitable MNEs in the world and not all entities covered by Pillar Two.

4 United States Implementation

The political reality is that there is unlikely to be a global agreement without the support of the United States. There are three potential levels of support in the United States – bipartisan support allowing for Senate ratification of US treaty amendments, sufficient support to pass US domestic legislation,[16] and the support of the Administration without an ability to pass legislation through Congress.

[16] This paper puts to one side the issue of whether the relevant US domestic legislation would require 50 or 60 votes in the Senate. In particular, whether the required legislation would be consistent with the Byrd rule and

Before considering what is required, it is worth considering whether this design is likely to be acceptable to the United States. In this context, it is very important to separate two concepts. The first is increasing tax in the market jurisdiction on certain US headquartered MNEs – this is a crucial element of Pillar One, without which there simply cannot be a multinational agreement. That is, Pillar One must reallocate some of the profit of US headquartered MNEs to be acceptable to the rest of the world. The second concept is a reallocation of profit which is currently booked (and taxed) in the United States to market jurisdictions (that is, a reallocation of taxing rights from the United States itself to the market jurisdiction). This is not a crucial element of Pillar One. For the agreement to be politically acceptable, it does not need to reallocate part of the tax base over which the United States has primary taxing rights[17] to market jurisdictions.

There is a reasonable expectation that the residual profits which are earned by US headquartered MNE's from their sales to the rest of the world are not currently being taxed at full rates in the United States. Put differently, a significant portion of the residual profits which arise from the sales of US headquartered MNEs to the rest of the world are not being booked and taxed in the United States (outside the GILTI regime). They are being taxed (if at all) in low-tax jurisdictions outside the United States. To the extent that there are residual profits being taxed in the United States, these profits are mostly arising from the US market and not from sales to consumers in the rest of the world.

The United States would only cede taxing rights under the proposed design if it were the lowest taxed jurisdiction in the MNE with Excess Profits. If the residual profits arising from sales to the rest of the world are not being taxed in the United States, it would be surprising if the lowest taxed jurisdiction in a US headquartered MNE was the United States itself. Under the proposed design, if more than 25% of residual profits are located in jurisdictions with Excess Profits and an ETR below that of the United States, then the United States will ***not*** be a ceding jurisdiction. The extent to which this mechanism would identify the United States as the ceding jurisdiction is an important empirical question. It is the author's understanding that the United States would rarely be identified as the ceding jurisdiction for significant revenue under this design. If this is incorrect, this proposal is unlikely to gain the support of the United States. However,

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capable of passing through the budget reconciliation process. For further analysis on this issue, see Mindy Herzfeld, Can the United States Make Good on Its International Tax Commitments?, *Tax Notes International*, 15 November 2021. For present purposes, the author acknowledges that there may be little practical difference in the short to medium term of domestic legislation requiring 60 votes and a requirement for a 2/3 majority in the Senate as both are likely to require bipartisan support.

[17] Note that the United States does not have ***primary*** taxing rights with respect to income subject to tax in the United States under the GILTI or Subpart-F regimes.

whether or not this claim is correct should be capable of reasonable estimation for in-scope MNEs for Pillar One.

Importantly, to the extent that all or substantially all of the Excess Profits of the MNE group are being booked in the United States, it is likely that the Amount A allocation would allocate the vast majority of the total Amount A to the United States. As the Excess Profit is being taxed in the United States, this Amount A allocation would be expected to be reduced by the marketing and distribution safe harbor.

The proposed design is likely to be attractive to the United States because it does not reallocate taxing rights from the United States to other countries. Instead, it is reallocating taxing rights from the current low tax jurisdictions in which it is currently being booked towards market jurisdictions. The jurisdictions which are losing these taxing rights are the ones that are not using them to raise significant taxes in the first place.

If the United States is unlikely to be a ceding jurisdiction, there is limited downside to the United States joining the Pillar One agreement. However, what about upside? What is in it for the US? First, the United States would be entitled to its own Amount A allocations from other MNEs. This could be a significant gain for a country with a very large consumer market. Second, the United States would gain by being able to participate in the tax certainty process. While beyond the scope of this article, Pillar One envisages a tax certainty process in which states are involved in a process to grant tax certainty to in-scope MNEs. The United States would be strongly motivated to be a part of this process particularly where it would impact so many US MNEs. Third, the United States is a strong supporter of Pillar Two and other states have argued that the Pillars need to be adopted as a package. Agreeing to Pillar One would likely increase the prospects of a global adoption of Pillar Two which benefits the United States.

Considering these benefits, there would appear to be at least prima facie grounds upon which bipartisan support may be achievable for this design of Pillar One. If the design will not result in the US ceding taxing rights and there are so many associated benefits to the United States of joining the agreement, it may be possible to achieve the support of both parties and therefore a 2/3 majority in the Senate. If this were achieved, then there would be no limitation on adopting Pillar One (that is, treaties could be amended and ratified as necessary). However, a key benefit of this design is that by leveraging the Pillar Two infrastructure it does not require the amendment of US tax treaties to operate.

As outlined above, an incentive is created for the MNE to pay the relevant Amount A Tax Liability from somewhere in the relevant group. As the design does not rely upon isolating a particular entity which may

have treaty protection, the incentive to pay the required amounts to the market jurisdiction exists even in the absence of treaty changes (that is, even if relevant entities in the group are treaty protected). Accordingly, the United States would be able to implement this Pillar One design through domestic law.[18] It is important for the United States to pass domestic legislation for at least three key reasons.

First, it is necessary to ensure that double taxation is relieved if the United States does happen to be the ceding jurisdiction (though this is expected to be unlikely). Second, the United States would may need domestic legislation in order for the United States to participate fully in the regime. This would include collecting its Amount A Tax Liability payments from other MNEs and participating in the agreed tax certainty process along with a variety of other elements. Finally, the regime passing through United States Congress is important for legitimacy reasons. Pillar One would be a significant shift in the international tax system and, if it is to be supported by the United States, it ought to go through US Congress. Adopting Pillar One through domestic legislation would appear to be consistent with Treasury Secretary Yellen's statement raising the question as to what 'form' of Senate ratification would be required.[19]

While it is important to recognise the need for US domestic legislation to adopt Pillar One, it is also important to consider whether the consequences would be unacceptable if the implementing legislation were to stall in Congress. Under the proposed design, if Pillar One were to come into operation before implementing legislation passed US Congress, the relevant MNEs would still be properly incentivised to make their Amount A Tax Liability payments. The top-up tax regime works without the domestic legislation in the United States so long as the Pillar Two infrastructure of the IIR and UTPR is sufficient to incentivise the payment. Furthermore, double taxation would still be avoided unless there were no other jurisdictions in the group with both sufficient Excess Profits and a lower ETR than the United States. As noted above, this seems unlikely. As a result, the regime could, if absolutely necessary, operate on a temporary basis prior to US domestic implementing legislation.

5 Conclusion

There has been significant pessimism that an acceptable Pillar One can be agreed by the Inclusive Framework and implemented by the United States. The starting point for that pessimism has been an

[18] This paper puts to one side whether domestic legislation could or should be accompanied by a 'congressional-executive international tax agreement'. See further Mindy Herzfeld, Can the United States Make Good on Its International Tax Commitments?, *Tax Notes International*, 15 November 2021.
[19] Treasury Secretary Yellen Testimony to the US Senate Finance Committee, 7 June 2022 (see https://www.c-span.org/video/?c5018385/user-clip-toomey-oecd-etc).

assumption that Pillar One would require US treaty ratification which is unachievable in light of the current political climate in the United States.

In this article I have proposed a Pillar One design which seeks to leverage key elements of the Pillar Two infrastructure to achieve an outcome which may be acceptable to all parties. The proposal leverages the concepts of top-up tax liabilities, Excess Profit and the Effective Tax Rate of a jurisdiction – all of which have been agreed by the Inclusive Framework in the context of Pillar Two. The result is to reallocate taxing rights to market jurisdictions from the lowest tax jurisdictions where MNEs are currently booking their Excess Profits. This is a fair and logical place from which the relevant profits ought to be reallocated.

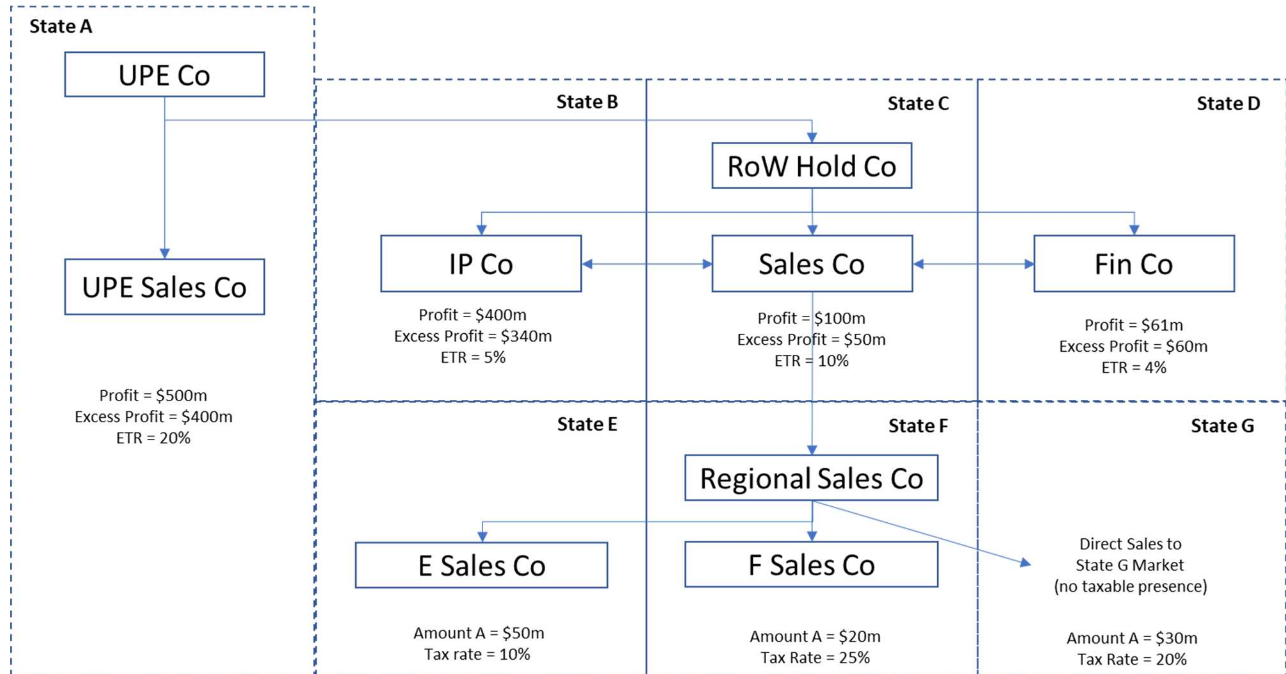
The outcomes of this design are such that there are large benefits to the United States joining the agreement and few drawbacks. Accordingly, there are good reasons to be optimistic that bipartisan support could be achieved which would meet the requirement to ratify a tax treaty. However, even if that outcome were not achieved, the proposal is capable of implementation by the adoption of domestic legislation in the United States. This process would still pass US Congress which is important both for its smooth operation and for legitimacy reasons. However, even in the worst-case scenario where domestic law changes in the United States were unachievable (at least temporarily), the outcome could still be acceptable to rest of the world on an interim basis and should not be actively resisted by the United States.

There is also a final benefit of this proposal in that it provides a mechanism for tying Pillar One to Pillar Two. Some countries and commentators have argued that the Pillars Project is a 'package deal' and it is inappropriate for Pillar Two to be adopted without Pillar One. This proposal remains agnostic on that question. If a decision were made to proceed with Pillar Two in advance of Pillar One, this mechanism could be subsequently adopted and 'tacked on' to the Pillar Two infrastructure which was already in place. Alternately, if it were necessary to tie the Pillars together to achieve implementation, the intertwined links between the two would allow a mechanism for achieving that outcome as well. Accordingly, while the proposal does not require the regimes to be tied together, the interactions could be used to achieve that outcome if it were politically necessary to achieve agreement and implementation.

In this article I have attempted to set out the contours of a design for Pillar One which could be supported and implemented by the entire Inclusive Framework including the United States. It is not expected that this proposal will be a perfect 'solution' for Pillar One. Its purpose is to advance the conversation and ideally provide a basis for a way forward which could be accepted by the Inclusive Framework and support multilateral efforts to reform the international tax system.

Appendix – A detailed example

Consider the following MNE Structure:



In this example, there is an MNE which is headquartered in State A (its Ultimate Parent Entity is in State A). It has domestic operations in State A which produce a large amount of profit – including Excess Profit. These are taxed within State A at 20%.

The MNE's operations outside State A are held through a 'Rest of World' Holding Company in State C (RoW Hold Co). The operations in State C both sell to the domestic market but also act as an entrepreneurial entity for the rest of the group. All of the global sales entities for markets outside of State A are held by Sales Co in State C. There are some domestic sales in State C but these are not particularly significant. Most of the profit of this entity arises from returns from sales to the rest of the world.

The MNE also has an IP Co in State B and a Financing Company in State D (Fin Co). There are significant Excess Profits in these jurisdictions and they are subject to tax at low effective tax rates (5% and 4% respectively). The income of these entities arises from royalty payments and interest payments from Sales Co.

The MNE has adopted a Regional Sales Co for a region consisting of State E, F and G. The group has a subsidiary in State E (E Sales Co) and a domestic sales subsidiary in State F (F Sales Co). There is no taxable presence in State G, but sales are made directly from Regional Sales Co in State F into State G.

The proposal would apply to this simplified group as follows:

Step 1 – Determine the Amount A Allocation

As noted above, for the purposes of this proposal it is assumed that there is an acceptable mechanism for determining the Amount A allocation to each of the market jurisdictions. In this case, there are three countries with an Amount A allocation – States E ($50m), State F ($20m) and State G ($30m). There is no Amount A allocation to State A because of the Marketing and Distribution Safe Harbor (MDSH). There is already sufficient Excess Profit being taxed in State A that the Amount A allocation is reduced to zero under the MDSH. This is also true of State C. Accordingly, there is no Amount A Allocation to States A, B or C. The total Amount A Allocation for the group is $100m.

Step 2 – Imposing the Amount A Tax Liability

The second step is to impose the Amount A Tax Liability with respect to States E, F and G. As noted above, there may be optionality regarding how the market jurisdiction imposes the relevant tax on the MNE group. How the states address this issue may differ depending upon domestic legal obstacles on the relevant jurisdiction.

Assume that State E imposes the liability on the MNE's domestic entity, E Sales Co. This is relatively simple. State E is entitled to impose this tax on its domestic resident entity (regardless of any tax treaty). State E's Amount A allocation is $50m and it imposes a 10% tax rate, resulting in an Amount A Tax Liability of $5m payable by E Sales Co.

State F similarly imposes the tax liability on the relevant domestic entities. However, this is slightly more complicated as the Amount A Tax Liability must be imposed on Regional Sales Co and/or F Sales Co. Both of these entities are resident entities of State F and therefore there are not treaty limitations. It is up to State F how it wishes to impose the new tax liability between resident entities in its jurisdiction. However, the tax liability will be the Amount A allocation multiplied by the applicable rate (here 25%) producing an Amount A Tax Liability of $5m ($20m * 25%).

For State G, there is no MNE entity which is resident in State G. Accordingly, the Amount A Tax Liability cannot simply be imposed by State G on a domestic resident. The solution is that it is up to the MNE group

to identify a paying entity in order to make the payment obligation to State G. This could include imposing joint and several liability on the MNE group or imposing a tax liability on the ultimate parent entity of the group. State G is entitled to a $30m Amount A allocation and has an applicable tax rate of 20%. Accordingly, a $6m Amount A Tax Liability is expected to be paid by the MNE group to State G.[20] Generally, it would be up to the MNE which entity paid the Amount A Tax Liability to State G. Importantly, even if the relevant entity or entities required by State G are treaty protected, payment is incentivised by leveraging the Pillar Two top-up tax infrastructure.

For each State above, there is an addition to the relevant Jurisdictional Top-up Tax to ensure the MNE makes the relevant payment. As noted above, there are two options for design. Under Option 1 (the Tax Indifference Model) the Jurisdictional Top-up Tax is designed to make the MNE pay the same amount of tax regardless of whether it pays the market jurisdiction or the IIR jurisdiction. This model assumes that the MNE is sufficiently motivated to pay the market jurisdiction by another feature of the rules.[21] Under Option 2, there would be an additional financial incentive to pay the market jurisdiction rather than the IIR jurisdiction.

This example applies Option 1 to State G for illustrative purposes. The additional Jurisdictional Top-up Tax is calculated according to the following formula:

$$\begin{aligned} &Jurisdictional\ Amount\ A\ Top-up\ Tax \\ &\quad = (Amount\ A * Jurisdictional\ Tax\ Rate) - \ Amount\ A\ Tax\ Liability\ Payments \end{aligned}$$

Applied specifically to State G,

$$\begin{aligned} &(State\ G)\ Jurisdictional\ Amount\ A\ Top-up\ Tax \\ &\quad = (\$30m * 20\%) - \ Amount\ A\ Tax\ Liability\ Payments \\ &\quad = \$6m - Amount\ A\ Tax\ Liability\ Payments \end{aligned}$$

As long as any entity in the MNE group has paid State G the $6m Amount A Tax Liability, there will be no additional top-up tax under this enforcement mechanism. However, if the MNE fails to make its Amount A payment to State G, it will owe the same liability ($6m) under the IIR or UTPR. The mechanism must impose the Jurisdictional Top-up Tax regardless of whether or not the UPE has adopted the IIR. If State A

[20] For States E and F, this outcome can be achieved merely by an inclusion in the income of the relevant entities rather than the imposition of a particular tax liability. For State G, there is no such entity and therefore it is important to impose the liability and not just have an inclusion.

[21] For example, exclusion from the relevant tax certainty process agreed under Pillar One.

has a qualified IIR, the Jurisdictional Top-up Tax would be due to State A (as the UPE jurisdiction). If State A has not imposed a qualified IIR, the tax would be imposed under the UTPR.[22]

In the example, the MNE can choose any entity in the group to make the payment to State G. However, no tax deduction ought to be given for the paying entity under their domestic tax system. The aim is to relieve the double taxation through Step 3 – and therefore no relief ought to be available to the *paying* entity.[23]

Step 3 – Identifying the ceding jurisdictions

The third step is to identify a ceding jurisdiction to avoid double taxation. This is done by identifying the jurisdictions in the group with Excess Profits and determining their ETRs. Both of these concepts are contained in Pillar Two. As all entities within Pillar One are covered by Pillar Two, the MNEs subject to Pillar One will already need to calculate these concepts for each jurisdiction. This example does not consider a cap on the reallocation of Excess Profits from a ceding jurisdiction as a potential design variation (outlined above).

In this case, there are four jurisdictions which have Excess Profits.

	Profit	**Excess Profit**	**ETR**	**Ceding Allocation**
State A	$500m	$400m	20%	-
State B	$400m	$340m	5%	$40m
State C	$100m	$50m	10%	-
State D	$61m	$60m	4%	$60m

There is $100m of Amount A which needs to be allocated amongst the jurisdictions with Excess Profits. As State D is jurisdiction with the lowest ETR (4%), it is the first jurisdiction in the 'waterfall' allocation.

It is determined to be the allocating jurisdiction up to the full amount of its Excess Profit ($60m). There is no allocation beyond its Excess Profits. The remaining $40m can all be allocated to State B. Accordingly,

[22] There is a question as to whether an 'intermediate IIR' could be utilised. The difficulty is that there is not necessarily a relevant Constituent Entity which could be subject to a particular IIR (there is no particular entity from which the payment must be made). Accordingly, it may be necessary to use the UTPR in the absence of an IIR in the UPE jurisdiction. Of course, if GILTI is considered to be a 'Qualified IIR' (without an equivalent rule), there would need to be a rule to ensure that this liability was still imposed.
[23] Of course, if the ceding entity is the paying entity, relief would be granted.

there are two ceding jurisdictions under the proposed rule – State B ($40m) and State D ($60m). Neither State A nor State C receive an allocation as the ceding jurisdiction as their ETR's are too high.

Once State B and State D are determined to be the ceding jurisdictions, they are required to relieve the double-taxation to the extent of their allocation. They are entitled to use either the exemption or credit method. State B adopts for the exemption method and State D adopts the credit mechanism.

State B has adopted the exemption method. Accordingly, double tax is avoided by granting an exemption for the $40m of profit it has ceded to the market jurisdictions. State B may be entitled to some latitude in how this exemption is to be provided (for instance, against which types of income it is to apply etc.).

State D has adopted the credit method and therefore must determine what tax credit ought to be made available to the MNE. As there is no 'tracing' from this ceding jurisdiction to a particular Amount A, State D must provide a credit for a proportionate share of the taxes imposed by market jurisdictions on the Amount A allocation.

The available credits are determined as follows:

	Amount A Allocation	**Tax Rate**	**Amount A Tax Credits**
State E	$50m	10%	$5m
State F	$20m	25%	$5m
State G	$30m	20%	$6m
		Total	$16m

State D has ceded $60m of a total $100m in Amount A. Accordingly, 60% of the available Amount A tax credits are attributable to profits ceded by State D. State D therefore provides tax credits of $9.6m ($16m * 60%) to the resident entities of the MNE.

There is a question as to what limits State D can apply to the use of these credits. For instance, the ceding jurisdiction is likely to want to limit the credits to offsetting the taxes which would have been available had the income been taxed in that jurisdiction. That way, the ceding of Amount A to higher tax countries would not give rise to a broader reduction in the state's tax revenue.

What if some of the jurisdictions do not implement Pillar One?

States A and C

If State A does not impose Pillar One, there is no difference in the outcome under this example. State A is not entitled to any Amount A allocation. Even though it is a market jurisdiction, there is sufficient profit booked in the jurisdiction that there is no Amount A allocation due to the MDSH. State A is also not a ceding jurisdiction. There is sufficient Excess Profit being booked in jurisdictions which have lower ETRs than State A to cover the allocations under the proposal's waterfall structure.

As a result, Pillar One would impose the same tax liabilities regardless of whether State A implements Pillar One or not. The only difference would be whether State A has adopted a qualified IIR which implements this Pillar One mechanism (this could be separated from a qualified IIR under the GloBE Rules). If it has, then the Jurisdictional Amount A Top-Up Tax could be imposed by the UPE if the MNE does not make the required Amount A payment to State G. However, this is only a back-up tax and it is not expected to raise any actual revenue as the MNE is incentivised to pay the market jurisdiction. Furthermore, even in the absence of a qualified IIR in the UPE jurisdiction, the top-up tax would be imposed by other jurisdictions under the UTPR.

Like State A, State C is neither entitled to an Amount A allocation, nor is it a ceding jurisdiction. There is no substantial difference in whether or not it signs up to Pillar One.

States B and D

If States B and C do not sign up there can be unrelieved double taxation. This is a necessary outcome of a system which attempts to reallocate profit to market jurisdictions. The revenue must come from somewhere and if those countries refuse to make an offsetting adjustment, there will be double taxation. However, there are several important features to note. First, the structure of the proposal is such that these will necessarily be jurisdictions with high excess profits and low tax rates. States offering low taxes on large amounts of Excess Profit should not be expected to deliberately impose double taxation on MNEs operating within their jurisdiction. Furthermore, if they were to do so, we would expect the MNE to be incentivised to relocate the profit to a jurisdiction which did relieve double taxation.

Finally, if the MNE is to be subject to double taxation, it will be subject to double taxation in its lowest taxed jurisdictions – this should (at the very least) minimise the damage of double taxation. In this case, State B is expected to cede $40m and applies a 5% rate while State D is expected to cede $60m and has a

4% rate.[24] This would lead to additional taxation of $2m and $2.4m respectively. These are relatively small amounts in the context of this example.

States E, F and G

States E, F and G are all entitled to an Amount A allocation and are not ceding jurisdictions. If one or more of them do not sign up, the jurisdiction would simply not be entitled to any Amount A. This will not negatively impact the other jurisdictions.

[24] For simplicity, this example assumes that the ceding jurisdiction's avoidance of double tax would have relieved tax at the ETR for the jurisdiction. However, the ETR is a blended rate across the jurisdiction. The domestic rules to relieve double taxation may not result in relief provide at the ETR but could be at a higher or lower rate depending upon the design.

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