THE NATIONAL FOREIGN TRADE COUNCIL

SUBMISSION OF WRITTEN COMMENTS FOR THE HEARING RECORD

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TAXATION

HEARING ON OECD PILLAR ONE: ENSURING THE BIDEN ADMINISTRATION PUTS AMERICANS FIRST

March 21, 2024

Mr. Chairman, Ranking Member, and Members of the Subcommittee:

The National Foreign Trade Council (the "NFTC") is providing written comments as part of the record for the *Tax Subcommittee Hearing on OECD Pillar 1: Ensuring the Biden Administration Puts Americans First*, held on March 7, 2024. We thank Chairman Jason Smith, Ranking Member Neal, Subcommittee Chairman Mike Kelly and Subcommittee Ranking Member Mike Thompson for holding a hearing on this important issue.

The NFTC, organized in 1914, is an association of U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD and the Inclusive Framework ("IF") in establishing and maintaining international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations. We further value the work and efforts of the Congress and the U.S. Department of the Treasury ("Treasury") in defending and advancing the interests of U.S. businesses.

General Comments

NFTC and our members are interested in a successful outcome of the Pillar One negotiations. A successful outcome would stabilize the international tax system by eliminating digital services taxes and other unilateral measures (together, "DSTs") that disproportionately target U.S. technology companies, providing for a principled reallocation of taxing rights and minimizing complexity, uncertainty, and the potential for double or excessive taxation. The Pillar One negotiations are important to addressing the lack of stability within the current system and the threat of numerous unilateral and discriminatory DSTs targeting U.S. companies. It is vital that we prevent the spread of additional discriminatory tax measures that specifically target American companies and industries. We urge the United States to stay at the table and negotiate the best resolution possible for U.S. businesses and the U.S. economy.

The draft Multilateral Convention ("MLC") to implement Pillar One, published in October 2023, is a significant step forward in the Pillar One negotiations. NFTC welcomed the consultation on the MLC held by Treasury last year. During that consultation, we outlined our concerns while reinforcing the call for continued negotiations resulting in a global commitment to a successful outcome.

The appeal of the Pillar One proposal for U.S. businesses lies in both its components, Amount A and Amount B. Amount A would permit a reallocation of taxing rights (i.e., a shift of income, referred to as Amount A, to "market jurisdictions" to be subject to net tax by such jurisdictions) in exchange for the elimination of DSTs. Amount B aims to create a simplified approach for benchmarking routine returns for distribution activities, thereby reducing or eliminating disputes in this contentious area.

At this point, even with the significant progress made, numerous technical and policy issues remain. Many of these issues are outlined below. Due to the number of outstanding issues, NFTC is still considering whether we can support the MLC. We urge Treasury and the other IF members to continue their work and resolve the outstanding issues in a manner that is principled, avoids undue complexity, and avoids double taxation, and is to the benefit of all U.S. based multinational enterprises ("MNEs").

The critical role the Congress plays in Pillar One cannot be understated. Pillar One cannot move forward without the implementation of Pillar One in U.S. law. (In this respect, Pillar One is very different from the domestic minimum taxes being adopted by many countries as a result of Pillar Two). Implementing Pillar One into U.S. law would require the United States to adopt the MLC through legislation and as a treaty, and to adopt significant changes to the Internal Revenue Code. Such changes would be unprecedented and therefore, would be difficult even with broad consensus as to the advisability of Pillar One. The stakes are high. The failure of Pillar One work could result in the proliferation of DSTs targeted at U.S. companies with unpredictable consequences. But an unprincipled or deficient Pillar One deal would also have negative consequences, including tax uncertainty, complexity, double taxation, and replacing one unstable system with several overlapping systems. We respectfully suggest that the Committee continue to engage with U.S. businesses, Treasury, and other stakeholders as this process moves forward to maximize the potential for a successful outcome.

Specific Comments

Elimination of DSTs and Similar Measures

A critical objective of Pillar One is the elimination of DSTs and similar measures (such as significant economic presence ("SEP") nexus rules). These taxes are discriminatory because they intentionally target U.S. technology businesses. And they are unfair because they are imposed on gross revenues without regard to whether there was a profit or a loss.

The MLC does not yet meet the objective of eliminating DSTs and similar measures. To highlight one example, the current definition prohibits taxes that are "discriminatory" based on narrow and loose standards that would permit countries to continue to apply DSTs. We urge policymakers to ensure that Pillar One actually accomplishes the goal of eliminating DSTs by providing a broad and unambiguous definition of prohibited taxes that look to the predominant effect of the tax rather than stated intent or other subjective or ambiguous criteria.

Technical Operation of Amount A - Sourcing Rules

The sourcing rules of Pillar One are foundational because they are used to determine the countries to which income may be reallocated to (or from) under Pillar One. In many cases, these rules are complex, unworkable, and arbitrary. While the current MLC incorporates some comments from businesses and therefore represents a step forward from earlier drafts, further changes are necessary.

To highlight one example, the sourcing rules for services provided to "large" commercial customers generally rely on a headcount allocation. These rules are not practical and overly burdensome. Taxpayers would need to segregate their customers into subsets and then obtain customer-specific (and non-public) information as to those customers' headquarters locations.

A separate example is component manufacturers, who often sell their products in bulk to a limited customer base. The ultimate end use or destination of their components is largely unknown to the manufacturer. These manufacturers, who are in the scope of Amount A, must deal with tax uncertainty and unnecessary compliance complexity. Thus, they must use allocation keys and make estimates based largely upon the Gross Domestic Product ("GDP"). Determinations based on the OECD allocation key will result in the largest allocations going to the U.S., China, and Germany.

To highlight another example, the sourcing rules for services provide that customers should be segregated into three categories (small, large, and resellers). In theory, separating customers into three buckets and applying a tailored allocation method seems logical. In practice, applying different allocation methods may require information not routinely contained in systems or obtained from customers as a matter of course. At times, customers are also resellers, which would require segregating the revenues between those that relate to the seller as a customer versus those that relate to resale transactions in order to apply the different sourcing criteria. This is seemingly impractical and, in some cases, impossible.

Technical Operation of Amount A -- Marketing Distribution Safe Harbor ("MDSH")

The MDSH is important to the operation of Pillar One because it ensures that market jurisdictions do not receive a double allocation of profits. The MDSH in the current MLC needs refinement before finalization. We are concerned that many of the design elements are not based on economic principles and are seemingly arbitrary. We have requested that the OECD provide a rationale as to the design elements chosen. Without ties to an economic principle, these elements are arbitrary, thereby making them susceptible to future adjustments based on political or other considerations. It would be difficult to obtain the goal of stability if these values are subject to future adjustment.

We are concerned because the MDSH does not fully eliminate double allocations of profit, thereby creating an incentive for market jurisdictions to audit taxpayers and increase taxable income outside of Amount A. This may allow jurisdictions to collect additional revenue (irrespective of the arm's length principle) without impacting their guaranteed Amount A allocation. In order to safeguard against this, and as discussed below, we have recommended mandatory implementation of Amount B as an optional safe harbor on which taxpayers can rely. In its current form Amount B has a limited scope which may not mitigate disputes as envisioned. Tax authorities will simply focus the activities and functions outside the scope of Amount B.

We are also concerned that the MDSH reaches inappropriate results in the case of franchise or split-ownership business models. The MDSH in the current MLC only accounts for residual profits earned by entities whose results are consolidated with the taxpayer. The profits earned by unconsolidated franchisees or distributors in the market jurisdiction are not taken into account, even in cases in which such entities earn a share of the residual profits from the overall supply chain. This would result in a double allocation of residual profits to market jurisdictions and would create significant economic distortions as the profits from the overall supply chain would be taxed differently depending on whether a taxpayer operated through consolidated or unconsolidated franchisees or distributors. We urge policymakers to address this issue and ensure that the MDSH is neutral across business models.

Technical Operation of Amount A -- Adjustment for Withholding Taxes

The current MLC introduced a mechanism to account for withholding taxes imposed by a market jurisdiction, which reduces the Amount A allocation to that market jurisdiction. Like the MDSH, an adjustment mechanism to account for withholding taxes is critically important to ensure that market jurisdictions are not permitted double allocations of income. We are concerned that the adjustment mechanism in the current MLC will not be effective and will lead to double taxation. The adjustment mechanism falls short of requiring a dollar-for-dollar adjustment for withholding taxes. While we understand that this measure was the result of a political compromise with jurisdictions that rely on withholding taxes, we note that several such jurisdictions have reserved this point. More fundamentally, anything short of a dollar-for-dollar adjustment for withholding taxes will have the perverse effect of endorsing existing withholding taxes on income, such as royalties or service fees, or even encouraging the introduction or increase of such taxes in contravention of long-standing U.S. policy. We urge policymakers to push for a dollar-for-dollar adjustment for withholding taxes.

Technical Operation of Amount A -- Double Taxation and Coordination with Pillar Two

Pillar One introduces new risks of double taxation, in particular, the risk that the income allocated to market jurisdictions will nevertheless continue to be taxed in the jurisdiction in which it was actually earned and reported. The current MLC provides limited assurances that the obligation to relieve double taxation will be fully satisfied. We are also concerned that the alternative mechanisms proposed to relieve double taxation may not work as seamlessly as envisioned, given the potential issues involving integration with existing domestic tax regimes. We request policymakers to provide further guidance in the MLC to ensure full relief from double taxation on any Pillar One tax liability.

We understand that the integration of Pillar One and Pillar Two will be part of the Pillar Two discussions. Several clarifications are needed, including an ordering rule and confirmation that Pillar One tax should be treated as a Covered Tax in the relieving jurisdiction rather than the jurisdiction of the Designated Payment Entity. Clarifications as to whether Global Anti-Base Erosion Model Rules ("GloBE") income adjustments are necessary to incorporate the surrender effects of Pillar One calculations is also needed. In addition, Amount A is optional for countries to implement, which includes both relieving jurisdictions and recipient jurisdictions. This optionality creates the potential for double taxation. This could occur when a recipient jurisdiction determines that a digital services tax or other similar tax raises more revenue and thus there's no incentive to comply or when a relieving jurisdiction opts out from providing relief from double taxation on profits reallocated to market jurisdictions. These issues must be addressed in order to ensure the integrity of the system and ensure the goal of Amount A eliminating discriminatory taxes. Supporting the implementation of Amount A and Amount B without knowing the link between these two concepts and without knowing what the relation is with Pillar Two is concerning.

Amount A -- Tax Certainty & Mutual Agreement Procedure ("MAP")

Tax certainty is a central tenet of Pillar One. The current MLC introduced novel concepts, such as reallocating the tax base of America's biggest corporations to foreign governments, to attempt to provide such certainty. In general, these provisions favor jurisdictions with broad tax treaty networks. NFTC continues to advocate for countries, particularly the United States, to build upon their existing networks of bilateral tax treaties. We note again that the United States has a relatively narrow network of tax agreements compared to other countries; for example, the United States does not have tax agreements covering Singapore, Hong Kong, most of Latin America, and most of Africa. This relatively narrow network puts the United States at a competitive disadvantage and may reduce the benefits of the dispute resolution mechanisms being developed by the IF. We urge U.S. policymakers to recommit themselves to the U.S. tax treaty program, bring additional transactions and arrangements under these dispute resolution mechanisms, and further pledge the NFTC's continued support for these efforts.

The dispute resolution procedures outlined in the current MLC can be improved. For example, we have requested that a binding timeline be created to ensure timely dispute resolution. Tax disputes in foreign jurisdictions can take years or even decades to resolve. Any extension of this timeline should require the consent of the affected taxpayer. Without such a timeline, uncertainty will become widespread due to the layers of impacts contained in Pillar One and potentially Pillar Two.

The MLC also includes some verbiage suggesting that jurisdictions may disregard the rules. In the spirit of encouraging dispute resolution and stability, these references should be removed. To the extent there are policy issues underlying such language, those issues should be addressed in a more tailored manner so as not to frustrate the resolution of disputes and the avoidance of double taxation.

Amount A -- Taxpayer Data

The MLC requires detailed calculations involving sensitive taxpayer data. We urge policymakers to develop additional guardrails to mitigate the distribution of sensitive taxpayer data and to limit the use of that data to the greatest extent necessary. Deterrence and protective measures must be put in place for any breaches of confidentiality since taxpayers cannot rely on each country's domestic protections.

Amount B

Amount B could be a critical part of the Pillar One work if it provides a simplified and streamlined approach to determine the returns to distribution and marketing activities, thereby limiting tax disputes in this contentious area. At present, Amount B does not meet its objectives because it is too limited in scope and because jurisdictions can choose not to apply it (or even respect the application of Amount B by other jurisdictions). To be effective, Amount B should be mandatory for all jurisdictions and provided as an optional safe harbor for all taxpayers in the scope of Amount A. The scope of Amount B, currently limited to the distribution of goods, should be broadened to all distribution and similar activities, including distribution in relation to services and digital property and retail with no "ring fencing" of distribution activities or exclusions. No qualitative criteria should be accepted, and vague concepts that would decrease the certainty of Amount B should be removed.

As currently designed, Amount B is optional for tax authorities to apply. This is counter to the underlying purpose of creating certainty. For example, New Zealand has announced that not only will they not apply Amount B, and they will also not allow for correlative adjustments when profits taxed in New Zealand are taxed somewhere else as a result of Amount B. Uneven adoption of Amount B could create additional instability in the system rather than creating the stability and dispute prevention it was intended to create.

It is important to ensure that taxpayers can rely on Amount B and that the scope of Amount B is expanded. The failure to include digital goods and services ignores the modernization of the global economy, which was part of the impetus of this project. The OECD has failed to show that distribution activities of digital goods and services vary significantly from that of tangible goods. Transfer pricing disputes on these items are rampant and will only continue to increase over time. Providing a reasonable deemed return on routine distribution activities makes sense for both taxpayers and tax administrators. This allows the dedication of limited resources to truly complex or novel issues. Further work must be done on the pricing matrix particularly with respect to sovereign risk adjustments, which require allocations beyond an arm's length return in certain jurisdictions. We urge Congress to work with Treasury in pushing the OECD to improve the current guidance related to Amount B.

Conclusion

We recognize the significant progress that has been made to date on Pillar One. That said, several important outstanding issues remain with the current MLC and with Amount B, as detailed above and in our December 12, 2023, comment letter to Treasury. We appreciate the Subcommittee's interest in this critical issue and its engagement with the business community on these matters. Due to the number of outstanding issues, we suggest Congress continue engagement as this process unfolds.

As we are still considering whether we can support the MLC, we urge the parties to continue their work to resolve the outstanding issues in a manner that is principled, avoids undue complexity, and avoids double counting or double taxation of the same income. We believe that any negotiated outcome that falls short of these objectives will ultimately fail to bring stability to the international tax system.

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Thank you for the opportunity to submit these written comments for the record. The NFTC looks forward to working with you, your staffs, and all Members of the Committee to ensure that Pillar One does not adversely impact the competitiveness of the U.S. economy and of worldwide American companies.

We are happy to answer any questions or provide clarification on any of the issues raised. Please contact Anne Gordon, Vice President for International Tax Policy at agordon@nftc.org.