PILLAR ONE AMOUNT A TAX GAMES

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Pillars One and Two Blueprints & Economic Impact Assessment (2020 & 2021)

Amount A through the Lens of the EIA….One Year Later

1. Eden, Lorraine. 2020. **Leap of Faith**: The Economic Impact Assessment of the Pillar One and Pillar Two Blueprints. *Tax Management International Journal,* 49 (Dec. 11). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3743054

2. Eden, Lorraine. 2020. **Winners and Losers**: The OECD's Economic Impact Assessment of Pillar One*. Tax Management International Journal,* 49 (Dec. 11). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3743059

3. Eden, Lorraine. 2021. **Pillar One Tax Games**. *Tax Management International Journal*, 50 (Jan 4). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3758671

4. Eden, Lorraine. 2021. **Canada and the United States: Winners or Losers** from Pillar One Amount A? *Tax Management International Journal,* 50.3 (March): 143-147. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3800026

5. Eden, Lorraine. 2021. The **Simple Analytics** of Pillar One Amount A. *Tax Management International Journal*, 50.3 (March): 137-143. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3800017

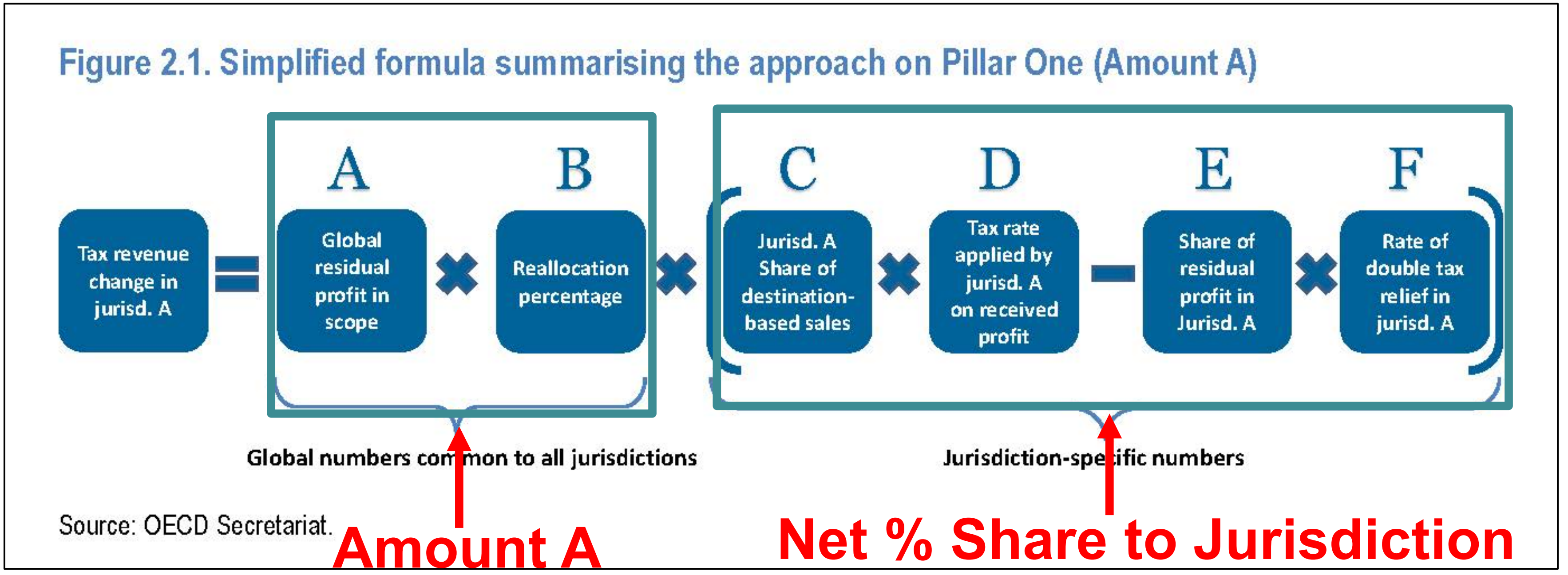
6. Eden, Lorraine. 2021. **Winners and Losers: U.S. Country and Industry Estimates** of Pillar One Amount A. *Tax Management International Journal*, 50.5 (May): 222-243. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3841813

7. Eden, Lorraine. 2021. **Taxing the Top 100**: U.S. Estimates of Winners and Losers from Pillar One Amount A. *Tax Management International Journal*, 50.6 (June): 301-317. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3862062

Pillar One Amount A Formula

Jurisdiction J's Net Tax Revenue Gain/Loss =

(A * B) * [(C * D) – (E * F)] (1)



Source: OECD *Economic Impact Assessment* (Oct. 12, 2020, page 29).

Simple Analytics of the Amount A Formula

- **Jurisdiction J's Net Revenue Tax Gain/Loss =**

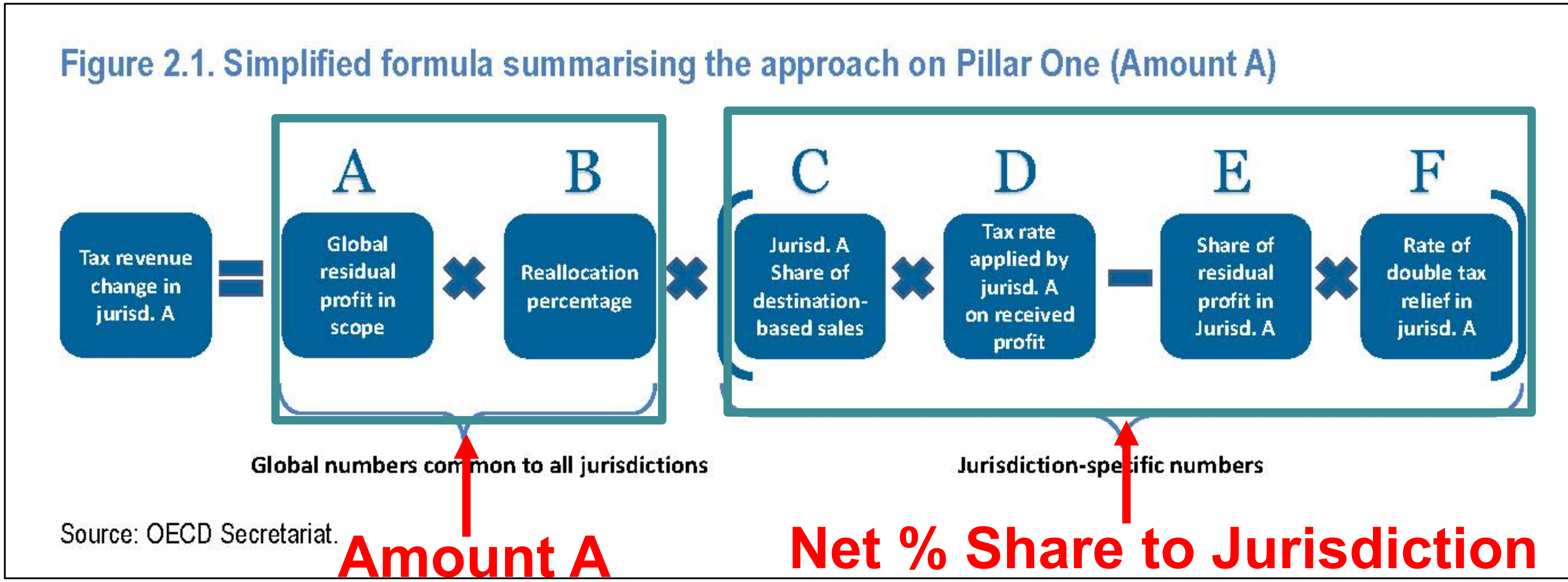
  (A * B) * [(C * D) – (E * F)] (1)

- In equation (1), components **A and B** in the formula are **global numbers** that are identical for all tax jurisdictions.

- **C, D, E, and F are jurisdiction-specific variables** that vary for each jurisdiction depending on its roles as a
  - **Market jurisdiction (C x D)**
  - **Residence and/or Source jurisdiction (E x F).**

Insight #1: Raising/Lowering A or B Raises/Lowers Amount A

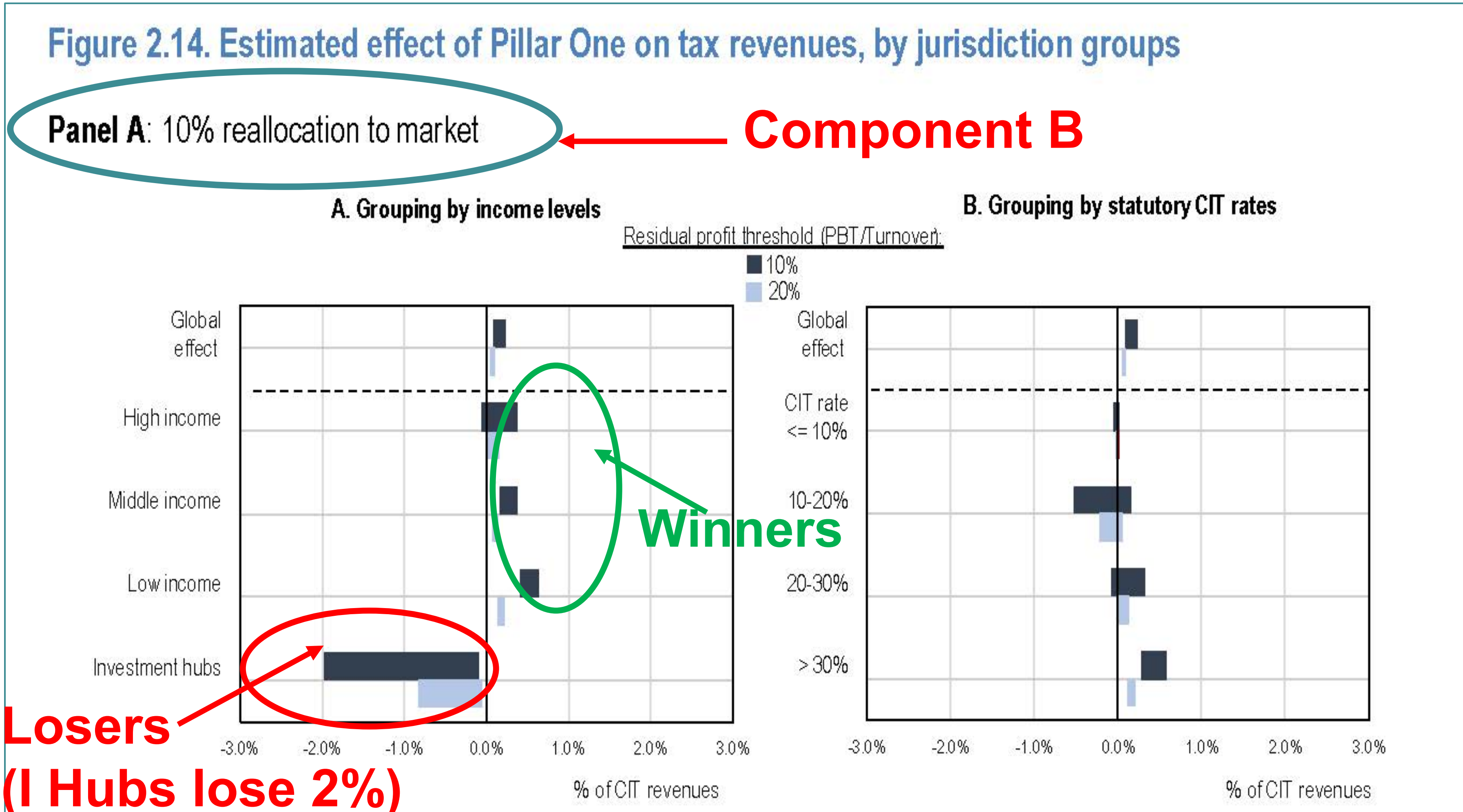
J's Net Tax Revenue Gain/Loss = (A*B) * [(C*D) – (E*F)]



In-Scope? Global Profit? Residual Profit Threshold? Allocation Percent?

Source: OECD *Economic Impact Assessment* (Oct. 12, 2020, page 29).

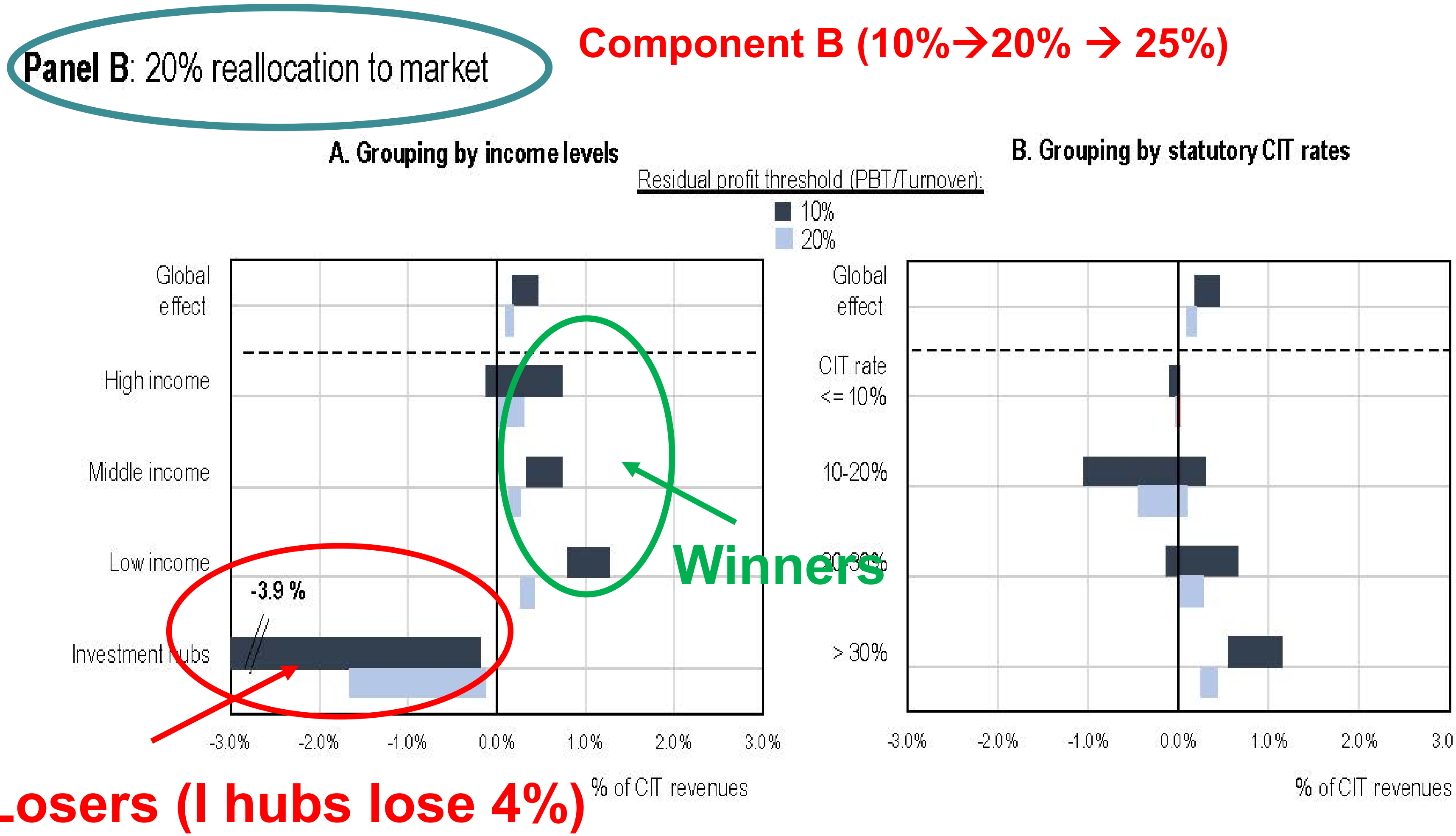
Winners and Losers from Amount A (EIA, 2020)



Source: OECD *Economic Impact Assessment* (Oct. 12, 2020, page 61).

Winners & Losers from Amount A (EIA 2020)

Component B (10%→20% → 25%)



Source: OECD *Economic Impact Assessment* (Oct. 12, 2020, page 62).

Insight #2: C- E Gap Matters Most

Assume J's CIT rate (component D) on "received" tax base is the same rate (component F) that J provides on "relieved" tax base so **D = F = t**, equation (1) becomes:

J's Net Revenue Gain/Loss = [A * B] * t * [C – E]

$$= \quad \underbrace{[A \times B]}_{\text{Amount A}} \quad * \quad t \quad * \quad \underbrace{[C - E]}_{\text{J's Net Gain/Loss Tax Base}} \qquad (2)$$

Whether J gains or loses from Amount A depends on its C-E gap; that is, its share of GIDS relative to its share of GRIP.

To determine who wins/loses from Amount A, look at the <u>sign and size of the jurisdiction's C – E gap.</u>

Insight #3: Amount A = Sales-Based Global Formulary Apportionment

To estimate the dollar value of the gain or loss in each jurisdiction's corporate income tax (CIT) base under Amount A, I rewrite Component C as "$S/\sum S$" where "$\sum S$" is GIDS, and Component E as "$P/\sum P$" where "$\sum P$" is GRIP. Amount A now is:

- **Net gain/loss in J's CIT revenues = $t * [B * S (\sum P/\sum S - P/S)]$**
- The greater the **deviation of J's ROS from the world average ROS**, the larger (in absolute value terms) is J's tax base gain or loss.
- **Winners: stagnant economies (low P/S)** are tax base receiving.
- **Losers: dynamic jurisdictions (high P/S)** are tax base relieving.
- Large winners are countries where S is large but no nexus (no PE) so profits are recorded elsewhere (e.g., ADS).
- Large losers are jurisdictions with very high profits relative to in-country sales so P/S approaches infinity. Even where S is low, these jurisdictions (e.g., investment hubs) are likely targets to provide tax base relief under Amount A.

Example 1: Winners/Losers Investment Hubs (USD Billion)

	Jurisdiction Group	Com-ponent C	Component E & Thresholds		(C - E) Gap & Thresholds	
			10%	20%	10%	20%
Juris-diction of Ultimate Parent (Res-idence)	High Income (64)	44,875	414	149	NA	NA
	Middle Income (105)	12,424	34	10		
	Low Income (29)	80	0	0		
	Investment Hubs (24)	5,996	45	15		
	Total (222)	63,375	493	174		
	% share, High Income (64)	70.8%	83.8%	85.7%	**-13.0%**	**-14.8%**
	% share, Middle Income (105)	19.6%	7.0%	5.5%	**12.7%**	**14.1%**
	% share, Low Income (29)	0.1%	0.0%	0.0%	0.1%	0.1%
	% share, Investment Hubs (24)	9.5%	9.2%	8.8%	0.3%	0.6%
Juris-diction of Foreign Affiliates (Source)	High Income (64)	40,599	288	90	NA	NA
	Middle Income (105)	17,580	59	15		
	Low Income (29)	130	0	0		
	Investment Hubs (24)	5,066	146	70		
	Total (222)	63,375	493	174		
	% share, High Income (64)	64.1%	58.4%	51.4%	**5.6%**	**12.7%**
	% share, Middle Income (105)	27.7%	11.9%	8.5%	**15.9%**	**19.2%**
	% share, Low Income (29)	0.2%	0.0%	0.0%	0.2%	0.2%
	% share, Investment Hubs (24)	8.0%	29.7%	40.1%	**-21.7%**	**-32.1%**

Example 2: Winners/Losers High-Income Jurisdictions as Proxy for Canada & USA (Two-Arrow Approach)

Residence Jurisdictions (Location of Ultimate Owners)

Source Jurisdictions (Location of Foreign Affiliates)

	HI Americas	HI Europe & Central Asia	HI East Asia & Pacific	HI M. East & N. Africa	Relative to HI Group	Relative to All Jurisdictions
HI Americas	HI Americas as Residence	HI Americas as Source			-3.8%	-1.1%
HI Europe & Central Asia					1.4%	1.8%
HI East Asia & Pacific					2.7%	2.3%
HI M. East & N. Africa					-0.3%	-0.1%
Relative to HI Group	-8.1%	0.8%	7.0%	0.4%	0.0%	2.8%
Relative to All Jurisdictions	-7.5%	-0.4%	4.3%	0.2%	-3.4%	0.0%

Example 3A: US Country/Industry Impacts Using BEA Data on MOFAs and MOUSAs (US v ROW)

Residence Jurisdictions (Location of Ultimate Owners)

Source Jurisdictions (Location of Foreign Affiliates)	Canada	United States	Europe	LAMEA	Asia Pacific	World
Canada		6.4% $7.3B				
United States	-4.0% -$1.6B		-10.9% -$4.4B	6.3% $2.5B	8.7% $3.5B	0.0% $0.0B
Europe		-4.8% -$5.4B				
LAMEA		-4.3% -$4.9B				
Asia Pacific		2.6% $3.0B				
World		0.0% $0.0B				

MOUSAs (US Inward FDI)

MOFAs (US Outward FDI)

Example 3B: Amount A Impacts by Industry (US vs ROW)

	Sales ($M)	Profit ($M)	ROS	C	E	C – E	Impact ($M)
	MOFAs (U.S. Direct Investment Abroad)						
Mining	112,327	57,219	50.9%	3.0%	10.0%	**–7.1%**	**–8,042.3**
MFG	1,530,926	220,919	14.4%	40.7%	38.8%	1.9%	2,175.5
Wholesale	789,998	67,813	8.6%	21.0%	11.9%	9.1%	10,360.0
Retail	356,329	18,148	5.1%	9.5%	3.2%	6.3%	7,160.7
INFO/ADS	164,562	55,354	33.6%	4.4%	9.7%	**–5.3%**	**–6,087.6**
FIN&INS	204,664	102,201	49.9%	5.4%	17.9%	**–12.5%**	**–14,242.6**
Services	230,560	39,433	17.1%	6.1%	6.9%	–0.8%	–904.8
OTHER	375,602 [3]	8,965	2.4%	10.0%	1.6%	8.4%	9,580.9
ALL IND	3,764,968	570,051	15.1%	100.0%	100.0%	0.0%	0.0
	MOUSAs (Foreign Direct Investment in the United States)						
MFG	1,798,267	104,061	5.8%	40.0%	51.8%	**–11.8%**	**–4,742.3**
Wholesale	1,123,180	24,528	2.2%	25.0%	12.2%	12.8%	5,131.5
Retail	246,545	2,731	1.1%	5.5%	1.4%	4.1%	1,657.0
INFO/ADS	188,996	3,448	1.8%	4.2%	1.7%	2.5%	999.3
FIN&INS	485,050	47,805	9.9%	10.8%	23.8%	**–13.0%**	**–5,226.4**
Services	159,036	2,175	1.4%	3.5%	1.1%	2.5%	986.2
OTHER	455,526	16,225	3.6%	10.1%	8.1%	2.1%	825.7
ALL IND	4,497,890	200,973	4.5%	100.0%	100.0%	0.0%	0.0

Insight 4A: Pillar One Tax Games - Multinationals

An MNE can affect its global CIT taxes paid under Amount A, by :

- **Being excluded from Pillar One by not being in-scope (finance & insurance, extractive industries, state owned multinationals).**
- **Reducing the amount of its GRIP (global residual in-scope profit) in Tax Base Relieving Jurisdictions (C < E)**
  - **Reducing its residual profit by raising its routine profit (affects RPT)**
  - **Shifting its business lines into out-of-scope activities (definition of "in-scope" and activity tests)**
  - **Change mode of entry if doing so reduces GRIP**
- **Reducing its share of GIDS (global in-scope destination-based sales) in Tax Base Receiving Jurisdictions (C > E)**
  - **Change the Mode of Entry (e.g., wholly owned vs franchise) or where sales are booked (e.g., regional marketing hub) if doing so reduces GIDS**
  - **Shift out of Market jurisdictions where GIDS is low and not likely to grow**
- **Note: Transfer pricing would still be driven by tax differentials → MNE's goal is to maximize worldwide profits after tax.**

Insight #4B: Pillar One Tax Games - Governments

J's Tax Base Change = [**A * B] * [(C*D) – (E*F)]**

Assuming D = F = t then

- **J gains tax base if C > E (tax base receiving)**

→ **J's Goal: maximize its tax base gains from Amount A**

- **J loses tax base if C < E (tax base relieving)**

→ **J's Goal: minimize its tax base losses from Amount A**

Pillar One Tax Games: Governments

J's Tax Base Change = A * B * [C * D – E * F]

J can affect the size of its gain from Amount A by:

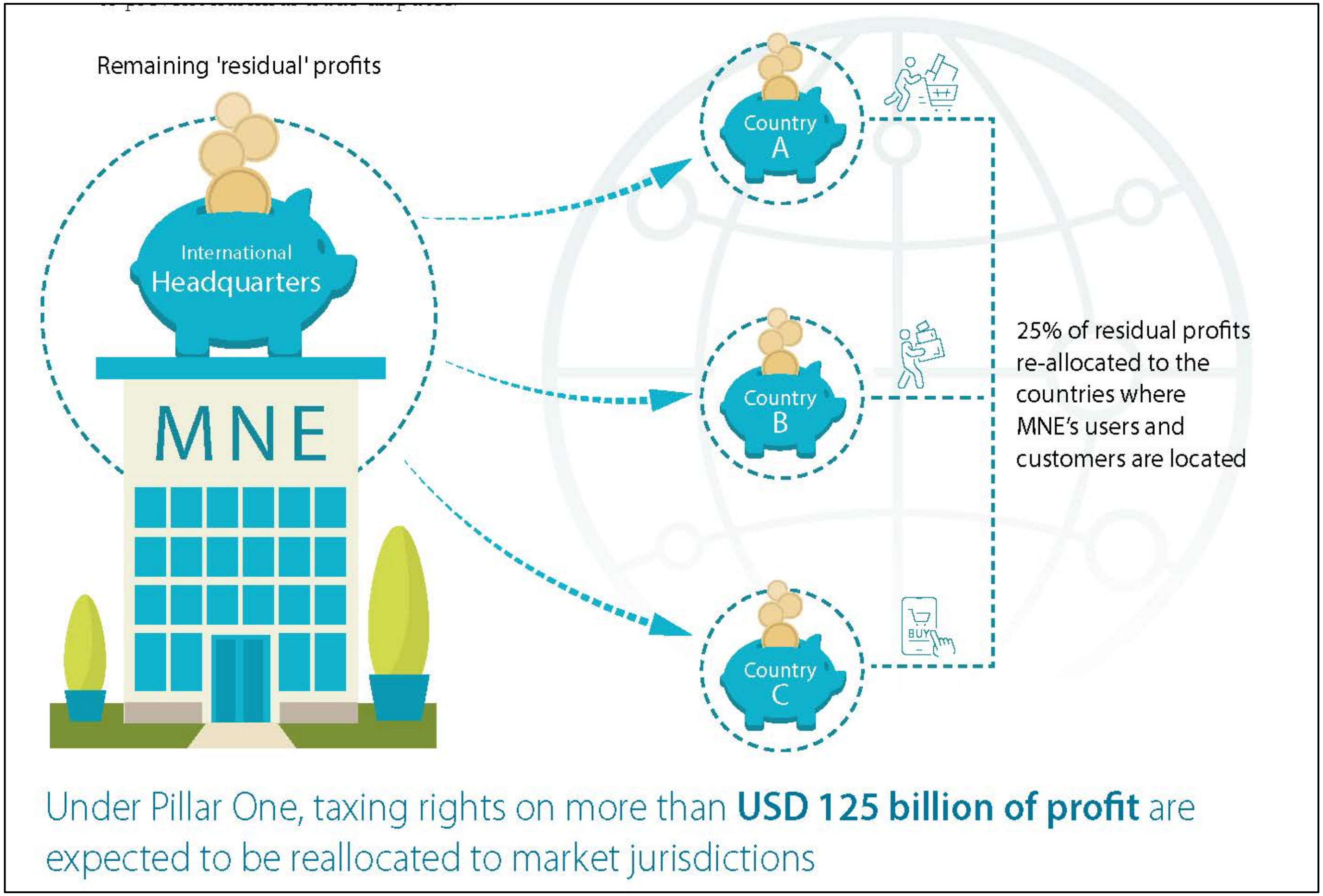
- **Increasing its share of GIDS (component C)**
  - **Playing with definitions: G + I + D + S**

- **Reducing its share of GRIP (component E)**
  - **Playing with definitions: G + R + I + P**
  - **No nexus so E = 0 (no Perm Est, Commissionaires, ADS sales)**

- **Tax rates (components D and F)**
  - **Setting a higher tax rate on "found" tax base than on "lost" tax base (D > F)**
  - **Refusal to provide tax relief on its share of GRIP that has been reallocated to Market jurisdictions (sets F = zero)**

→ Who provides tax base relief matters!

Tax Base Receiving → Who Provides Tax Base Relief?



OECD. Oct 2021. Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, page14.

Insight #5: Who are the "Tax Relieving" Jurisdictions?

Source: OECD *Pillar One Blueprint* (Oct. 12, 2020, Chapter 7, pp. 139-159 and 227-230).

Four-Step Tax-Relieving Process

1. **Activities** – entities performing nonroutine activities that make material and sustained contribution to the group's ability to generate residual profit (i.e., functions/assets/risks & DEMPE).
2. **Profitability** – exclude entities that make only routine profits or losses
3. **Market Connection Priority** – activities should be connected to the market jurisdiction
4. **Back-Stop (Pro-Rata Allocation)** – Last resort: allocate tax liability among group entities pro-rata until entity earns only routine profits. **(waterfall?)**

- Four-step process → Tax Base Relief provided by Residence and Source jurisdictions with MNE Parents, Principals & Full-Fledged Entities. What about investment hubs and tax havens?
- **Fuzziness of four-step process encourages Pillar One Tax Games ("Pass the Buck", "I Can't Pay the Rent").**
- **Decentralized MNEs encourage Tax Games by both MNEs & Governments.**

Tax Base Receiving & Relieving in Centralized MNE

ENTITY	Parent	LRD	LRD	LRD	LRD	MNE Group
COUNTRY	H	J1	J2	J3	J4	World
ALLOCATION OF MNE GROUP TAX BASE UNDER STATUS QUO ALP RULES						
Revenue	15,000	2,000	4,000	3,500	1,250	
Third-party revenue	10,000	2,000	4,000	3,500	1,250	20,750
Intragroup revenue	5000	0	0	0	0	
Costs (COGS + OE)	10,000	1,940	3,880	3,395	1,212	15,427
Profit before tax (PBT) (under ALP status quo)	5000	60	120	105	38	5,323
Profit margin (PBT/Revenue), %	33%	3%	3%	3%	3%	26%
TAX BASE RE-ALLOCATION UNDER AMOUNT A (BEFORE DOUBLE TAX RELIEF)						
Amount A (before double tax relief)	313	63	125	110	39	650
PBT under ALP + Amount A (before DT relief)	5,313	123	245	215	77	5,973
% change in PBT due to Amount A	6.26%	105.00%	104.17%	104.76%	102.63%	12.21%
Potential double counting	*313*	*0*	*0*	*0*	*0*	*313*
TAX BASE RE-ALLOCATION UNDER AMOUNT A (FULL DOUBLE TAX RELIEF BY JURISDICTION H)						
Netting-off of profits under DT relief	−650	0	0	0	0	−650
PBT under Amount A after DT relief	4,663	123	245	215	77	5,323
Net Change in PBT due to Amount A (after DT relief)	−337	63	125	110	39	0
% change in PBT due to Amount A (after DT relief)	−6.74%	105.00%	104.17%	104.76%	102.63%	0.00%

Source: OECD *Pillar One Blueprint* (Oct. 12, 2020, pp. 227-228) and Eden (2021) adaptation.

Who receives?
Entities with third-party revenues (all 5 entities)

Who pays?
4-step criteria (Parent)

Who doesn't pay?
Entities with routine returns or losses (LRDs)

Who does netting-off?
4-step criteria (Parent)

Winners: LRDs
Losers: Parent

NET IMPACT OF AMOUNT A IS ZERO

Tax Base Receiving & Relieving in Decentralized MNE

ENTITY	Parent	FFD	LRD	FFD	LRD	MNE Group
COUNTRY	H	J1	J2	J3	J4	World
ALLOCATION OF MNE TAX BASE UNDER STATUS QUO ALP RULES						
Revenue	2,000	4,000	2,000	3,000	3,000	
Third-party revenue	0	4,000	2,000	3,000	3,000	12,000
Intragroup revenue	2,000	0	0	0	0	
Costs (COGS + OE)	1,250	3,250	1,900	2,450	2,700	9,550
Profit before tax (PBT) under ALP status quo	750	750	100	550	300	2,450
Profit margin (PBT/Revenue), %	38%	19%	5%	18%	10%	20%
TAX BASE ALLOCATION UNDER AMOUNT A (BEFORE DOUBLE TAX RELIEF)						
Amount A before double tax (DT) relief	0	82	42	63	63	250
PBT under ALP + Amount A (before DT relief)	750	832	142	613	363	2,700
% change in PBT due to Amount A	0.00%	10.93%	42.00%	11.45%	21.00%	10.20%
Potential double counting of PBT	*0*	*82*	*0*	*63*	*0*	*145*
SCENARIO #1: TAX BASE REALLOCATION UNDER AMOUNT A (AFTER DOUBLE TAX RELIEF)						
Netting-off of profits under DT relief	−105	−82	0	−63	0	−250
PBT under Amount A after DT relief	645	750	142	550	363	2,450
Net Change in PBT due to Amount A	−105	0	42	0	63	0
% change in PBT due to Amount A	−14.00%	0.00%	42.00%	0.00%	21.00%	0.00%
SCENARIO #2: TAX BASE REALLOCATION UNDER AMOUNT A (AFTER DOUBLE TAX RELIEF)						
Netting-off of profits under DT relief	−168	-82	0	0	0	−250
PBT under Amount A after DT relief	582	750	142	613	363	2,450
Net Change in PBT due to Amount A	−168	0	42	63	63	0
% change in PBT due to Amount A	−22.40%	0.00%	42.00%	11.45%	21.00%	0.00%
SCENARIO #3: TAX BASE REALLOCATION UNDER AMOUNT A (AFTER DOUBLE TAX RELIEF)						
Netting-off of profits under DT relief	0	0	0	0	0	0
PBT under Amount A after DT relief	750	832	142	613	363	2,700
Net Change in PBT due to Amount A	0	82	42	63	63	250
% change in PBT due to Amount A	0.00%	10.93%	42.00%	11.45%	21.00%	10.20%

Source: OECD *Pillar One Blueprint* (Oct. 12, 2020, pp. 228-230) and Eden (2021) adaptation.

Scenario #2 (J3 – no tax relief)

Who receives?
J1, J2, J3, J4 (2 LRDs & 2 FFDs)

Who pays? H (Parent) & J1 (1 FFD)

Who doesn't pay?
J2 & J 4 (2 LRDs); J3 (1 FFD, doesn't play by the rules)

Who does netting-off?
H (Parent) and J1 (1 FFD)

Winners: J2 & J4 (2 LRDs); J3 (FFD)
Losers: H (Parent – backstop role)
No Change: J1 (FFD)

NET IMPACT OF AMOUNT A IS ZERO

Tax Base Receiving & Relieving in Decentralized MNE

ENTITY	Parent	FFD	LRD	FFD	LRD	MNE Group
COUNTRY	H	J1	J2	J3	J4	World
ALLOCATION OF MNE TAX BASE UNDER STATUS QUO ALP RULES						
Revenue	2,000	4,000	2,000	3,000	3,000	12,000
Third-party revenue	0	4,000	2,000	3,000	3,000	
Intragroup revenue	2,000	0	0	0	0	
Costs (COGS + OE)	1,250	3,250	1,900	2,450	2,700	9,550
Profit before tax (PBT) under ALP status quo	750	750	100	550	300	2,450
Profit margin (PBT/Revenue), %	38%	19%	5%	18%	10%	20%
TAX BASE ALLOCATION UNDER AMOUNT A (BEFORE DOUBLE TAX RELIEF)						
Amount A before double tax (DT) relief	0	82	42	63	63	250
PBT under ALP + Amount A (before DT relief)	750	832	142	613	363	2,700
% change in PBT due to Amount A	0.00%	10.93%	42.00%	11.45%	21.00%	10.20%
Potential double counting of PBT	*0*	*82*	*0*	*63*	*0*	*145*
SCENARIO #1: TAX BASE REALLOCATION UNDER AMOUNT A (AFTER DOUBLE TAX RELIEF)						
Netting-off of profits under DT relief	−105	−82	0	−63	0	−250
PBT under Amount A after DT relief	645	750	142	550	363	2,450
Net Change in PBT due to Amount A	−105	0	42	0	63	0
% change in PBT due to Amount A	−14.00%	0.00%	42.00%	0.00%	21.00%	0.00%
SCENARIO #2: TAX BASE REALLOCATION UNDER AMOUNT A (AFTER DOUBLE TAX RELIEF)						
Netting-off of profits under DT relief	−168	-82	0	0	0	−250
PBT under Amount A after DT relief	582	750	142	613	363	2,450
Net Change in PBT due to Amount A	−168	0	42	63	63	0
% change in PBT due to Amount A	−22.40%	0.00%	42.00%	11.45%	21.00%	0.00%
SCENARIO #3: TAX BASE REALLOCATION UNDER AMOUNT A (AFTER DOUBLE TAX RELIEF)						
Netting-off of profits under DT relief	0	0	0	0	0	0
PBT under Amount A after DT relief	750	832	142	613	363	2,700
Net Change in PBT due to Amount A	0	82	42	63	63	250
% change in PBT due to Amount A	0.00%	10.93%	42.00%	11.45%	21.00%	10.20%

Source: OECD *Pillar One Blueprint* (Oct. 12, 2020, pp. 228-230) and Eden (2021) adaptation.

Scenario #3 (full tax games)

Who receives?
J1, J2, J3, J4 (2 LRDs & 2 FFDs)

Who pays?
H, J1 and J3 should pay but choose not to

Who doesn't have to pay?
J2 and J4 (2 LRDS)

Who does netting-off?
H, J1 and J3 should but choose not to

Winners: J1-J4 (all gain tax revenue)
Losers: none
No Change: H (parent)

NET IMPACT: MNE GLOBAL TAX BASE RISES BY AMOUNT A.

"Who Pays the Rent?" Pillar One Tax Games

- **Amount A ignores Territorial Tax Systems**
  - **Residence Jurisdictions exempt Foreign Source Income from outward FDI. ("I already paid the rent!")**
  - **Source countries receive CIT Base – the FSI earned by foreign MNEs abroad (inward FDI).**

- **Source Jurisdictions with high-profit foreign MNEs** (e.g., US MOFAs in Europe) won't give up tax base and want to tax foreign MNEs ("I won't pay the rent!")

- Large players engage in **tit-for-tat retaliation**. ("If you won't pay the rent, I won't pay the rent!")

- **Prospect Theory** → Source countries already taxing foreign MNEs - giving up tax base is more costly than receiving ("I can't lose the rent!").

- **Small jurisdictions get side swiped** ("We never get the rent!").

"Who Pays the Rent?" Pillar One Tax Games

- **OECD's proposed solution (Oct 2021)?** New Multilateral Convention (MLC) with Mandatory Binding Arbitration (MBA) run by an Omniscient Benevolent Dictator (OBD) → MLC + MBA + OBM = "My Hero!"

- **Reality →**
- **Two-layer system**: existing Intl Tax Regime + Pillar One → double taxation.
- **MNEs will pay the rent in higher worldwide taxes. With FIN/INS, Nat Resources & State-owned MNEs out, majority of costs fall on US MNEs in ADS and Manufacturing sectors.**
- **There are better ways to tax MNEs in the digital economy.**