Convergence and Divergence of Global and U.S. Tax Policies

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In this article, Frieden and Angus describe the unprecedented convergence of international, federal, and state tax policies represented by the OECD/G-20 pillar 1 and 2 proposals; the importance of approaching U.S. tax policy from the perspective of aggregate federal and state tax impacts; and the potential risk of divergence between U.S. and global income tax rules that could result in a competitive disadvantage for the United States.

Introduction

The global tax system is on the brink of a historic change in international tax rules. The OECD has been working for almost a decade on consensus approaches for changing the rules of international corporate income taxation to adapt to the changing dynamics of globalization and digitalization. The OECD has 38 members (including the United States) that account for about one-half of the world's gross domestic product.[1] This work has been conducted under a mandate from the G-20.[2] Moreover, today there are 139 jurisdictions participating in this effort through the OECD/G-20 inclusive framework that together make up over 90 percent of the world's GDP.[3]

The current OECD-led global tax initiative, labeled when it began in earnest in 2019 as "addressing the tax challenges of the digitalization of the economy," is one of the most ambitious international tax undertakings ever, given its global reach. This latest project builds on a project initiated in 2013 to address policymaker concerns that the global tax architecture created opportunities for base erosion and profit-shifting activity by multinational corporations (MNCs). Because of that history, the current initiative is commonly referred to as the BEPS 2.0 project — a name that belies the fundamental nature of the changes in the global tax architecture contemplated, which would rearrange core building blocks of the global tax system that were not touched by the original BEPS project. The breadth of the project is underscored by a recent shift in how the OECD and others refer to the project, now describing it as addressing the tax

[1]The 38 countries in the OECD are Australia, Austria, Belgium, Canada, Chile, Colombia, Costa Rica, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Costa Rica joined the OECD in May 2021, so it is not included in any of the OECD statistics in this article. For the OECD GDP, see OECD, Gross domestic product (GDP) (indicator) (2021).

[2]The G-20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union. Together, the G-20 nations comprise roughly two-thirds of the world's population and 80 percent of global GDP.

[3]A list of the inclusive framework member jurisdictions can be found online.

challenges arising from the *globalization and digitalization* of the economy.[4]

The BEPS 2.0 project includes two parallel workstreams. First, pillar 1 continues the consideration of the impact of the growing digitalization of the economy on the effectiveness of long-standing international tax concepts that began with the original BEPS project. The pillar 1 proposals, if implemented, would transform the existing global tax architecture for a portion of global commerce by disregarding the permanent establishment (physical presence) standard and using a formulaic approach to assign a share of taxing rights over global business income to market countries (where consumers are located). These pillar 1 changes also are intended to result in the withdrawal of unilateral measures for addressing digitalization, such as individual country digital services taxes.

Second, pillar 2 expands on the earlier focus on reducing profit shifting by seeking to limit low-tax-rate competition among countries through new global minimum tax rules. The pillar 2 changes, if implemented, would supplement the source-based territorial tax approach used by most of the world's major economies with a "top-up" tax imposed on foreign income at an agreed minimum tax rate of at least 15 percent. Under the proposed global minimum tax rules, nations could counter low tax rates applied by other countries on income earned in those countries by imposing an immediate additional tax on that income to yield a combined tax at the agreed minimum rate.

The bold changes in international tax rules under consideration by jurisdictions in the OECD/G-20 inclusive framework are broadly modeled on corporate income tax policies already in place at the state and federal levels in the United States. The pillar 1 proposals bear strong resemblance to the economic nexus standards and market sourcing rules incorporated in U.S. state corporate income taxes, in many cases decades ago. The pillar 2 proposals rely heavily on concepts underlying the so-called GILTI and BEAT provisions[5] incorporated in U.S. federal tax law in 2017 through the Tax Cuts and Jobs Act.

Two potential levels of convergence arise in connection with the pillar 1 and 2 proposals. First, there is a convergence among the nations that have been working together to negotiate these global tax changes. In this regard, the OECD/G-20 project prioritizes multilateral consensus and coordinated approaches for the taxation of global business income over unilateral and nonuniform measures. If properly designed and implemented, convergence in global tax rules could provide benefits for both tax administrators and corporate taxpayers.

Second, there is a potential convergence between the corporate income taxes imposed at the state and federal levels in the United States and the corporate income taxes of other countries. The pillar 1 proposals do not go as far as U.S. state policies in shifting taxing rights to market jurisdictions, but they represent a first global step in that direction. Similarly, the pillar 2 proposals are not identical to the U.S. international tax provisions enacted by the TCJA, or to changes to those rules proposed by the Biden administration, but they do follow a parallel approach. Moreover, the Biden administration's pending proposals reflect a cross-pollination with the pillar 2 design as the former incorporate some elements of the latter.

The support of the Biden administration for both pillars 1 and 2 has fueled new momentum for the project during 2021. With pillar 1, the Biden administration has backed the overall approach of implementing new nexus and profit allocation rules expanding the taxing rights of market jurisdictions but has urged a change in the scope of businesses subject to the new rules that moves farther away from the original digital focus. With pillar 2, the Biden administration has strongly supported the global minimum tax rules but has encouraged the adoption of a minimum rate higher than had been the focus of discussion before this year.

Part 1 of this article discusses the emerging consensus on pillars 1 and 2, the roots of these

[4] OECD, "OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors" (July 2021).

[5] The global intangible low-taxed income rules are in IRC sections 250 and 951A, and the base erosion and antiabuse tax rules are in IRC section 59A.

proposals in U.S. state and federal precedents, and the connections between the global and U.S. approaches. The OECD/G-20 project is at a critical juncture. In meetings held in late June and early July, members of the inclusive framework reached agreement on key components of both pillars 1 and 2, and the G-20 finance ministers endorsed that conceptual agreement. The aim now is to finalize the agreement by October, when the G-20 finance ministers will meet midmonth and the G-20 leaders will gather for their annual summit at the end of the month. While substantial work must still be done, at this point, all indications are that a final agreement will be announced before year-end. Then attention will turn to implementation of the agreement, which will require substantial changes in national tax laws and tax treaties and will likely take several years or longer.

The emerging global convergence on fundamental changes to the architecture for taxing global business income modeled roughly on U.S. precedents, however, should not obscure signs that a significant divergence could develop between U.S. and global income tax rules. Until recently, the United States was a more skeptical participant in the OECD/G-20 BEPS 2.0 project. There has been concern that a central outcome of the project would be increased foreign taxes on U.S. MNCs, particularly on digital businesses. The United States also has its own unique blend of federal and state taxation that skews how global tax proposals translate to the United States. Finally, the Biden administration is adding another level of complexity to the mix with its parallel but distinct goal of increasing U.S. taxes on the domestic and foreign earnings of U.S. businesses to reverse some of the TCJA tax reductions and to pay for ambitious federal infrastructure and social spending programs. The administration's tax proposals will be considered in Congress this year as part of the ongoing work on a budget reconciliation bill.

These factors combine to create an environment in which the United States may adopt corporate tax rates and policies that are out of sync with prevailing international norms, thereby undermining the stability and global competitiveness of the U.S. tax system. Indeed, given the potential for congressional action in 2021 on the Biden administration's tax legislative proposals, it is likely that if any of the proposed changes to GILTI and other international tax provisions are enacted, those changes would take effect well in advance of pillar 2 legislation in other nations.

In Part 2 of this article, we evaluate some of the risk factors through the prism of the aggregate U.S. federal and state tax system as applied to global business income. This is particularly important given both the uniquely large state and local government share of all taxes in the United States and the shortcomings of treating federal and state taxes as two separate and disconnected spheres. A minority of other countries have strong subnational government tax systems, but the United States is one of only two OECD or G-20 nations with both significant state corporate income and sales tax systems, one of only three OECD nations where state and local governments account for one-third or more of all government revenues, the only country with a DST at the subnational level, and the only country without a broad-based consumption tax at the national level.

When U.S. federal and state tax systems are viewed as one integrated fiscal system, the risks of the United States ending up outside global tax norms become more apparent. Among the fault lines focused on in Part 2 are the potential that the United States could leapfrog other advanced nations and adopt a higher combined federal/state tax rate on domestic corporate income and distributions; adopt a higher combined federal/state minimum tax rate and broader tax base relating to the foreign income of U.S. MNCs than other countries apply to their MNCs; and unilaterally impose DSTs at the subnational level while other countries remove DSTs at the national level.

The potential for tax rate disparity is reinforced by the unique composition of taxes in the United States. As the only country in the world without a general consumption tax at the national level, the United States is dependent on income and social insurance taxes to pay for new federal programs or reduce federal debt. The design of the U.S. tax system, without significant structural change, makes it very likely that income tax rate disparity with other countries will increase in the future.

Our goal in this article is not to take a position on the optimal U.S. corporate income tax rates on domestic or foreign-source income, or to provide a critique of all the elements of the OECD/G-20 pillar 1 and 2 proposals or the Biden administration's U.S. tax proposals. There are significant policy choices to be made by the United States and other countries on how best to adapt and reform their tax systems to provide a level playing field while at the same time responding to tax challenges arising from the globalization and digitalization of the economy.

But we believe it is important to evaluate the impact of emerging global tax policies on the capacity of the United States to maintain a balanced and competitive tax system. Generally, governments can choose among taxes based on when money is spent (consumption taxes), when money is earned (income and social insurance taxes), and the value of assets (property- and capital-based taxes). A balanced tax system relies on a mix of revenue sources that meet key policy objectives such as equity, economic growth, transparency, ability to pay, and stability. A competitive tax system uses income tax rules that achieve parity or near parity with the income taxes imposed by other advanced nations on their own MNCs.

Background: From the Original BEPS Project to The Current BEPS 2.0 Project

To put the BEPS 2.0 proposals in context, it is useful to look at how the entire BEPS project has evolved. The first OECD report on BEPS was issued in February 2013, with the support of the G-20.[6] The 2013 report provides an overview of global developments affecting corporate taxation and reviews key principles that underlie the taxation of cross-border activities and the BEPS opportunities these principles may create. The 2013 report indicates the OECD's intention to draft an action plan to develop measures to address key BEPS pressure areas.

The OECD issued its BEPS action plan in June 2013, outlining 15 action areas, including action 1 on addressing the tax challenges of the digital economy; action 3 on strengthening controlled foreign company rules; action 5 on countering harmful tax practices of countries; action 7 on preventing the artificial avoidance of PE status; and actions 8-10 on assuring that transfer pricing outcomes are in line with value creation.[7] With the action plan, the OECD began a process for including the G-20 countries in the work on the BEPS project and set a timeline for completing work by the end of 2015.

Over the next two years, the work on the BEPS project proceeded with the OECD issuing numerous discussion drafts and holding public consultations, culminating with the issuance of final reports on all 15 actions in October 2015. The measures agreed upon ranged from minimum standards, which all participating countries committed to implement, to a variety of non-mandatory measures in the form of revisions to existing standards, common approaches, and guidance on leading practices, which were aimed at providing support to countries and facilitating convergence of national practices.[8]

The inclusive framework was created by the G-20 and OECD in 2016 to continue the work on the BEPS project with the involvement of other interested jurisdictions, including developing countries. Membership in the inclusive framework requires a commitment to the comprehensive BEPS package.

Regarding action 1 on addressing the tax challenges of the digital economy, the 2015 final report concluded that "the digital economy cannot be ring-fenced as it is increasingly the economy itself."[9] Several options to address the broader challenges of the digital economy were considered (including new nexus in the form of significant economic presence), but none were recommended in the report, in part because it was expected that the other BEPS measures would

[6]OECD, "Addressing Base Erosion and Profit Shifting" (2013). *See also* G-20 Finance Ministers Meeting Communiqué (Nov. 5-6, 2012) ("We also welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting.").

[7]OECD, "Action Plan on Base Erosion and Profit Shifting" (2013).

[8]OECD, "Explanatory Statement" (2015). Since 2015 many of the agreed measures have been implemented by countries around the world, including anti-hybrid rules, limitations on interest deductions, changes in transfer pricing rules related to intangible property, and CbC reporting requirements.

[9]*Id.* at 13.

have a substantial impact on issues that had been identified in the digital economy. The G-20 and OECD agreed to monitor developments in the digital economy and to make a determination, based on a broad look at the ability of existing international tax standards to deal with tax challenges raised by developments in the digital economy, as to whether further work on options in this area should be carried out.[10]

The inclusive framework jurisdictions continued their work and in January 2019 agreed to examine and develop, on a without-prejudice basis, proposals regarding profit allocation and nexus rules and new global minimum tax rules.[11] Following a public consultation seeking input from stakeholders on proposals to be examined under the two pillars, the inclusive framework jurisdictions in May 2019 agreed on a work program for both pillars with an ambitious timeline for completion by the end of 2020.[12]

In January 2020, following public consultations on both pillars, the inclusive framework jurisdictions agreed on an outline of the architecture for pillar 1 and welcomed progress on pillar 2.[13] In October 2020 the OECD released detailed blueprints for the two pillars, totaling almost 500 pages.[14] While the content of the blueprints was not fully agreed upon, the inclusive framework jurisdictions approved their public release and indicated that they viewed the blueprints as a solid basis for future agreement.[15] Both blueprints identify open issues and additional work to be done. The OECD issued a consultation document on the two blueprints and received more than 250 comment submissions from stakeholders.

Following the U.S. election in November 2020, there has been significant political-level focus on the project aimed at resolving key differences among countries. The Biden administration has expressed strong support, though it is seeking changes to both pillars.[16] During their June meeting, the G-7 finance ministers reached agreement on several elements, providing further momentum for the project.[17]

At the conclusion of two days of meetings of the inclusive framework jurisdictions, the OECD

[10] In March 2018 the OECD issued a report on developments regarding the digitalization of the economy, discussing value creation across different digital business models, providing an overview of tax policy developments relevant to digitalization, and describing challenges identified regarding the continuing effectiveness of international tax standards in light of digitalization. The report makes clear that at the time of its issuance, a significant divergence of views existed among participating countries on the need for any future changes in the international tax system to address digitalization. OECD, "Tax Challenges Arising from Digitalisation — Interim Report 2018: Inclusive Framework on BEPS" (2018).

[11] OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy — Policy Note" (Jan. 23, 2019).

[12] OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy," (Feb. 12-Mar. 6, 2019). OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising From the Digitalisation of the Economy" (2019) ("A growing number of jurisdictions are not content with the taxation outcomes produced by the current international tax system, and have or are seeking to impose various measures or interpretations of the current rules that risk significantly increasing compliance burdens, double taxation and uncertainty. . . . Cognisant that predictability and stability are fundamental building blocks of global economic growth, the Inclusive Framework is therefore concerned that a proliferation of uncoordinated and unilateral actions would not only undermine the relevance and sustainability of the international framework for the taxation of cross-border business activities, but will also more broadly adversely impact global investments and growth."). *Id.* at 7.

[13] OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising From the Digitalisation of the Economy," (Jan. 31, 2020). The inclusive framework statement also identified critical policy differences, including a U.S. proposal to implement pillar 1 on a "safe harbor basis" that raised concerns for many countries, as well as significant divergences of view on dispute prevention and resolution mechanisms, the amount of profit to be reallocated to market jurisdictions, and the continued application of DSTs. Also, it noted that more technical work was required. Political challenges continued during 2020, combined with the practical challenges of moving to all-virtual meetings as a result of the COVID-19 pandemic.

[14] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar One Blueprint: Inclusive Framework on BEPS" (2020). OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar Two Blueprint: Inclusive Framework on BEPS" (2020).

[15] OECD/G-20 inclusive framework on BEPS, "Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two" (Oct. 8-9, 2020).

[16] The Biden administration also made clear that it would not pursue the safe-harbor approach to pillar 1 that had been proposed by the Trump administration.

[17] G-7 Finance Ministers & Central Bank Governors Communiqué (June 5, 2021) ("We strongly support the efforts underway through the OECD/G20 Inclusive Framework to address the tax challenges arising from globalisation and the digitalisation of the economy and to adopt a global minimum tax. We commit to reaching an equitable solution on the allocation of taxing rights, with market countries awarded taxing rights on at least 20 percent of profit exceeding a 10 percent margin for the largest and most profitable multinational enterprises. We will provide for appropriate coordination between the application of the new international tax rules and the removal of all Digital Services Taxes, and other relevant similar measures, on all companies. We also commit to a global minimum tax of at least 15 percent on a country by country basis. We agree on the importance of progressing agreement in parallel on both Pillars and look forward to reaching an agreement at the July meeting of G20 Finance Ministers and Central Bank Governors.").

on July 1 released a conceptual agreement that has support from 133 of the 139 inclusive framework jurisdictions.[18] The conceptual agreement covers key components of the two pillars and indicates the intention to finalize the agreement in October together with a detailed implementation plan. At their July 9-10 meeting, the G-20 finance ministers endorsed the July 2021 agreement and the plans for finalization.[19]

Final agreement of the inclusive framework jurisdictions, if achieved, represents only the end of the beginning. The next phase of the project involves action at the individual country level to implement agreed rules under pillars 1 and 2 through changes in their domestic tax laws and treaty agreements. There is no historical precedent for global coordination on tax matters of this magnitude and complexity. While the path and timeline for the implementation process remain to be seen, the significant political interest in these global tax changes is expected to continue to drive activity around the world.

Part 1: The Convergence of Global, Federal, and State Tax Policies

Overview of Pillar 1 — Revisions to Long-Standing Nexus and Profit Allocation Rules

The OECD has long been the global champion and protector of the PE standard for determining taxable nexus, which is embodied in the OECD model tax convention,[20] and the arm's-length principle for allocating profits, which is embodied in the OECD transfer pricing guidelines.[21] Both of these standards are also enshrined in U.S. federal tax law and U.S. bilateral tax treaties.

The PE requirement confers taxing rights if a corporation has a fixed place of business, such as a factory, office, warehouse, or place of management, in the taxing jurisdiction. The arm's-length principle relies heavily on rules that align the distribution of taxing rights with the physical location of value-creating (income-producing) activities, not the location of the customer or the market.

The pillar 1 proposals would make fundamental changes to these long-standing cornerstones of the global international tax architecture. The centerpiece of pillar 1 is a new set of rules aimed at increasing the share of profits of a global MNC that is allocated to the jurisdictions where its customers are located, regardless of whether the MNC has a physical presence in those market jurisdictions. Pillar 1 would require extensive coordination and cooperation among tax authorities, not just in the implementation of the new rules, but in the ongoing application of the rules to global MNCs.

The Design and Scope of Pillar 1

At the center of pillar 1 is a new approach to dividing taxing rights among jurisdictions regarding global businesses in scope that would find nexus without physical presence and would apply a formulaic approach for reallocating a portion of profits to market jurisdictions. This formulaic allocation is largely independent of the allocations under traditional PE and transfer pricing analysis that generally assign taxing rights to the location of value-creating activities. The pillar 1 blueprint released in October 2020 refers to the taxing rights that would be gained by market jurisdictions under this approach as "Amount A."

The pillar 1 blueprint also includes a separate set of new rules that would provide a fixed return on specified baseline marketing and distribution activities in the market jurisdiction (referred to as "Amount B"). These rules would apply only where a global business has a traditional PE in the

[18] OECD/G-20 Base Erosion and Profit Shifting Project, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (July 1, 2021). The six inclusive framework jurisdictions that had not joined the agreement as of August 12, 2021, are Estonia, Hungary, Ireland, Kenya, Nigeria, and Sri Lanka.

[19] Italian G-20 Presidency, Third Finance Ministers and Central Bank Governors Meeting, Communiqué (July 9-10, 2021) ("After many years of discussions and building on the progress made last year, we have achieved a historic agreement on a more stable and fairer international tax architecture. We endorse the key components of the two pillars on the reallocation of profits of multinational enterprises and an effective global minimum tax as set out in the 'Statement on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy' released by the OECD/G-20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) on July 1. We call on the OECD/G-20 Inclusive Framework on BEPS to swiftly address the remaining issues and finalise the design elements within the agreed framework together with a detailed plan for the implementation of the two pillars by our next meeting in October.").

[20] OECD, "Model Tax Convention on Income and on Capital: Condensed Version" (2017).

[21] OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (2017).

market jurisdiction and are intended to eliminate a common source of disputes between taxpayers and tax authorities by providing a formulaic determination of the return for limited-risk distributors. The July 2021 agreement of inclusive framework jurisdictions describes Amount B as involving the application of the traditional arm's-length principle to in-country baseline marketing and distribution activities on a simplified and streamlined basis, taking into account the needs of low-capacity (under-resourced) countries. It indicates that the work on Amount B will be completed by the end of 2022.

From the outset of the pillar 1 discussions, the question of what businesses to include within scope of the proposed new approach to nexus and profit allocation has been contentious. Many countries, including the United Kingdom most vocally, favored limiting the new rules to digital businesses. The United States objected to a digital-only approach, asserting that digital businesses could not and should not be singled out for special tax treatment and advocating for the application of the new rules to other businesses when traditional profit allocation approaches may not assign sufficient value to the market location. The U.S. opposition to any attempt to ring-fence digital business activity was first communicated by the Obama administration in the original BEPS project, and it has continued into the BEPS 2.0 project through the Trump administration and now the Biden administration.

The pillar 1 blueprint defined scope using revenue-based thresholds designed to capture large MNCs with significant global activity, combined with business activity tests designed to capture MNCs that participate in a sustained and significant manner in the economic life of a market jurisdiction without necessarily creating a commensurate level of taxable presence in the market under existing global international tax rules. Under the threshold tests, the new rules would apply only to MNCs with annual consolidated revenues of at least €750 million, which is the threshold for application of the country-by-country reporting requirement developed in the original BEPS project.

The business activity tests described in the pillar 1 blueprint covered two categories: automated digital services and consumer-facing businesses. Automated digital services encompassed services that are provided over the internet or an electronic network with minimal human involvement. Consumer-facing businesses were defined as businesses that generate revenue from the sale of goods or services of a type commonly sold to consumers, including those selling indirectly through intermediaries or by way of franchising or licensing. The blueprint provided exclusions from scope for specific industries, including natural resources, financial services, construction, and international transportation.

In April U.S. Treasury representatives presented to the inclusive framework a proposal for a completely different approach to defining the businesses within scope of the new nexus and profit allocation rules, proposing to replace the qualitative tests reflected in the pillar 1 blueprint with a purely quantitative test based on revenue and profitability. This approach was described as eliminating the potential for subjectivity in application of the business activity tests. The U.S. Treasury outlined the intention that the revenue and profitability thresholds include in scope "the largest and most profitable" MNC groups without regard to industry or business model, with the objective of having the rules apply to "up to 100" MNCs.[22]

This proposal for a quantitative approach to scoping generated significant interest among inclusive framework jurisdictions, although some countries initially expressed concern that it shifted away from the original aim of addressing digitalization. Subsequent discussions focused on how to set the quantitative thresholds to ensure that global MNCs of particular interest to some countries are captured within scope. Also, extensive negotiations have taken place among countries regarding potential industry-based exclusions.

Following the G-7 finance ministers' endorsement of applying the new nexus and profit allocation rules to the largest and most profitable companies, the July 2021 agreement reflects the quantitative threshold approach,

[22]U.S. Treasury presentation to the steering group of the inclusive framework, quoted in Stephanie Soong Johnston, "U.S. Offers Key to Unlock Scope Issue in Global Tax Reform Talks," *Tax Notes Int'l*, Apr. 12, 2021, p. 147-149.

specifying that MNCs with global revenue of more than €20 billion and profitability of more than 10 percent would be in scope of the new rules.[23] The agreement further specifies that the extractive and regulated financial services industries would be excluded.[24] It also describes the potential for reducing the revenue threshold to €10 billion in the future, contingent on successful implementation of the new rules as determined based on a review to begin seven years after the agreement comes into force and be completed within a year.

Two Key Changes in Foundational Principles: Economic Nexus and Formulaic Market Allocation

The pillar 1 blueprint provides that the new nexus rules would apply only for purposes of the new allocation of taxing rights to market jurisdictions and are not intended to apply for any other tax or nontax purpose. The July 2021 agreement provides a special-purpose nexus rule based on revenue alone. Under this economic nexus approach, an in-scope MNC is considered to have nexus in a market country if it derives at least €1 million in revenue there. A lower threshold of €250,000 would apply in the case of countries with GDP below €40 billion. The agreement further provides that revenue would be sourced to the end-market country where goods or services are used or consumed. Detailed source rules for particular categories of transactions will be developed, with MNCs required to use a reliable method based on their own facts and circumstances.

As described in the pillar 1 blueprint and reiterated in the July 2021 agreement, once nexus is established, the new profit allocation rules would be applied on the basis of groupwide (or, when relevant, segment) profits, measured based on profit before tax determined under financial accounting standards with limited adjustments. For this purpose, losses are carried forward through an earn-out mechanism, reducing future profits subject to the new allocation.

The pillar 1 blueprint describes a three-step process for allocating a portion of profits to a market jurisdiction, and the July 2021 agreement fills in parameters for the first two steps. First, a profitability threshold would be applied, with only profits in excess of 10 percent of revenue (referred to as residual profits) subject to reallocation. Second, a reallocation percentage of between 20 and 30 percent would be applied to determine the share of such residual profits to be allocated to market jurisdictions.[25] Third, a revenue-based allocation key would be applied to determine how this profit amount is divided among market jurisdictions with nexus. To illustrate the application of these parameters, an MNC with total profits of 25 percent of revenue would be considered to have residual profit of 15 percent of revenue (the excess of 25 percent over the threshold of 10 percent), and profit of 3 to 4.5 percent of revenue (20 to 30 percent of the 15 percent residual profit) would be subject to allocation among the market jurisdictions with nexus.

The July 2021 agreement specifies that the group entity or entities that would bear the new tax liability to market jurisdictions would be drawn from those entities that earn profit above 10 percent. The agreement reiterates that double taxation of the profits allocated to market jurisdiction would be relieved using either the exemption or credit method.

Given the importance of tax certainty to businesses and tax authorities alike, the pillar 1 blueprint describes a multi-step dispute prevention process regarding application of the new nexus and profit allocation rules. The July 2021 agreement specifies that in-scope MNCs would benefit from dispute prevention and resolution mechanisms for all aspects of the new nexus and profit allocation rules in a mandatory and binding manner. However, it further notes that consideration will be given to providing only an elective dispute resolution mechanism for specific developing economies.

[23]In this regard, the July 2021 agreement provides that segmentation would be applied in exceptional circumstances, when a segment disclosed in the MNC's financial accounts would meet the scope rules on a stand-alone basis. This would bring such a segment in scope even if the MNC as a whole does not meet the scope thresholds.

[24]One recent analysis estimates that 78 MNCs would fall within this scope definition. Michael Devereux and Martin Simmler, "Who Will Pay Amount A?" Oxford University Centre for Business Taxation (July 2, 2021).

[25]Note that the precise reallocation percentage applicable to the deemed residual profit amount is an open question that remains to be addressed in the final agreement expected in October 2021.

Removal of Individual Country DSTs

The pillar 1 blueprint provides that a necessary element of a consensus agreement is commitment to the removal of "relevant unilateral measures" put in place by jurisdictions to address the same concerns that would be addressed on a coordinated basis under the new pillar 1 rules. From the outset of the project, the United States has insisted that this will require elimination of countries' DSTs.

The concept of a DST was originally developed by the European Commission as a temporary measure to be used only until the global architecture for applying corporate income tax could be adapted to provide taxing rights over profits to the countries where markets are served through digital means. The objective of pillar 1 is to reach a consensus agreement on new nexus and profit allocation rules, thus adapting the global income tax architecture and thereby fending off uncoordinated action through unilateral DSTs. The ambitious timelines set for the BEPS 2.0 project when it began in early 2019 were driven by the pressure of country interest in DSTs.

Notwithstanding the ongoing work on pillar 1, France became the first country to enact a DST in July 2019, with the tax applicable back to the beginning of 2019. This was followed by enactment of DSTs in the United Kingdom and other countries in Europe and beyond. DST legislation now has been enacted in numerous countries around the world, with other countries actively considering putting such rules in place.[26] Some, but not all, of these DSTs include sunset clauses tied to new pillar 1 rules.

The growing number of DSTs around the world has further complicated the inclusive framework discussions under pillar 1, requiring consideration of how removal of DSTs should be coordinated with the new nexus and profit allocation rules. With the United States, France, and the United Kingdom at the center of the dispute over DSTs, the agreement reached by the G-7 finance ministers at their June meeting represents a significant breakthrough on this coordination question. The meeting communiqué expresses the intention to provide for appropriate coordination between the *application* of the new international tax rules developed under pillar 1 and the removal of all DSTs and other relevant similar measures on all companies. The July 2021 agreement reiterates this intention. Thus, removal of DSTs is not required based on a final agreement under pillar 1, but only when the new nexus and profit allocation rules have been implemented and are applicable. At that time, removal of DSTs is required not just for those MNCs that are within scope of the pillar 1 rules, but for all companies.[27]

U.S. State Tax Precedents for Pillar 1

The pillar 1 shift to economic nexus and formulaic market allocation would apply not to all revenue streams, but only to a portion of the deemed residual profit of the largest and most profitable MNCs that are within the scope of pillar 1. Nevertheless, the pillar 1 changes represent a radical departure from the long-standing global tax architecture. To date, no country has widely incorporated these two concepts into its corporate income tax laws.

There is, however, a long-standing precedent for using both economic presence and formulary apportionment rules for taxing cross-border commerce. The U.S. states — alone among national and subnational tax systems in the world — incorporated these principles into their corporate income tax systems, in many cases decades ago.[28] All but one of the U.S. states with corporate income taxes require, or at least do not preclude, the use of an economic nexus standard for determining the jurisdictions with taxing rights over businesses.[29] Similarly, all the states with corporate income taxes use formulaic market

[26] Countries that have enacted DST legislation include Austria, France, Italy, Kenya, Sierra Leone, Spain, Tunisia, Turkey, and the United Kingdom. Countries have also put in place other unilateral measures aimed at taxing digital activity, including digital PE, VAT, and equalization levy rules. (Based on EY research.)

[27] It is not clear how broadly the removal requirement will extend to other forms of digital taxation beyond DSTs.

[28] *See generally* Karl A. Frieden and Stephanie T. Do, "State Adoption of European DSTs: Misguided and Unnecessary," *Tax Notes State*, May 10, 2021, p. 577.

[29] With the exception of Delaware, all states with a corporate income tax (and the District of Columbia) have broad nexus statutes with no explicit physical presence requirement or have economic nexus standards through the application of bright-line factor nexus standards (based on Council On State Taxation research). For corporate income tax purposes, states are still preempted by the federal protections in P.L. 86-272 from imposing an income tax return filing responsibility on a business that sells tangible personal property and whose only physical presence in the state relates to the solicitation of sales. Those federal protections are not afforded to companies selling services or licensing intangible property.

sourcing to some degree, and two-thirds of the states rely exclusively on market sourcing for the allocation of income to the states.[30]

The Historical Evolution of State Corporate Income Tax Principles

State corporate income taxes have followed a very different historical trajectory than similar national corporate income taxes. The introduction of state corporate income taxes in the United States in the second and third decades of the 20th century piggybacked on the enactment of the federal income tax in 1913.[31] Over the course of their 100-year existence, state corporate income taxes have largely conformed to federal income taxes for purposes of determining the types of income and deductions included in the tax base. But states have never linked explicitly to two of the key federal and global principles: (1) the PE standard used by the United States and other nations to determine the jurisdiction to tax; and (2) the rules used to allocate income based on the locations of value-creating activities and not the place of consumption.[32]

These deviations are partially attributable to states not being signatories to, nor bound by, U.S. treaties with foreign nations — primarily driven by the impracticality of involving states in international agreements.[33] But they are also the result of a nearly 75-year evolution of state jurisdiction and apportionment rules to adapt to the changing dynamics of interstate and global commerce. State income tax laws have inexorably moved away from predicating jurisdiction to tax on physical presence and assigning value based on a taxpayer's income-producing activities and toward a much more significant reliance on economic presence and market sourcing.

Initially, when most commerce occurred in one jurisdiction, differences between international and state tax principles were less obvious. But over time, as cross-border trade expanded and services, intangibles, and eventually digital commerce have grown in importance, the split in approaches has led to greater adaptability of state tax rules to new business models. States have been able to broadly tax service and digital-based businesses without the constraints of PE rules and value-creating-activity allocation methods.

The Early Adoption of State Allocation of Taxing Rights to Market Jurisdictions

The first of the two principles that emerged at the state level was market sourcing. Nearly 75 years ago, states developed a system for apportioning income between jurisdictions that, from the outset, included assigning at least one-third of taxing rights to the market state. The National Conference of Commissioners on Uniform State Laws (now the Uniform Law Commission) promulgated the Uniform Division of Income for Tax Purposes Act in 1957. UDITPA endorsed an equally weighted three-factor apportionment formula based on property, payroll, and sales.[34] The sales factor in the formula — originally designed to attribute income to states in which goods are consumed (destination-based) — served as a counterbalance to the property and payroll factors, which focused on where the goods were produced. UDITPA's three-factor apportionment method was incorporated into the Multistate Tax Commission's Multistate Tax Compact in 1967.[35] This formula constituted a dramatic change from global norms, which have continued to rely primarily on two of these factors — property and payroll — to allocate income based on the location of the value-creating activity.[36]

[30]Thirty-seven states and the District of Columbia use either a single sales factor or a heavily weighted sales factor as the general apportionment formula. Thirty-three states and the District of Columbia use a market-based sourcing rule to allocate the sales of services. Twenty-nine states and the District of Columbia both rely on a single sales factor or a heavily weighted sales factor and source the sales of services based on market-based sourcing rules (based on COST research).

[31]Liz Emanuel and Richard Borean, "When Did Your State Adopt Its Corporate Income Tax?" Tax Foundation (June 19, 2014). By 1935, 30 states had adopted corporate income taxes. *Id.*

[32]*See* Frieden and Do, *supra* note 28, at 590-592. During the first two-thirds of the 20th century, state income tax nexus and sourcing rules may have overlapped with federal and international rules, but this was a matter of choice, not because the state rules were coupled with federal tax law provisions.

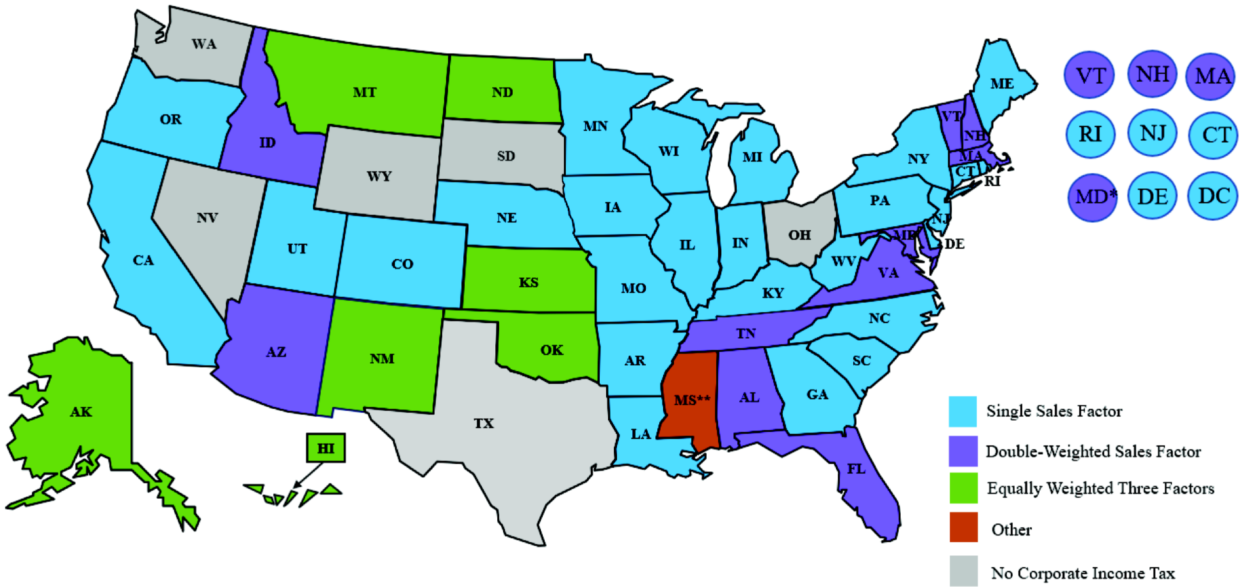
[33]U.S. tax treaties reflecting PE rules generally are not binding on states. *See* U.S. Model Income Tax Convention (2016), article 2, para. 3(b).

[34]7A U.L.A. 91 (UDITPA) (1978).

[35]Multistate Tax Compact, Article IV.

[36]The U.S. Supreme Court acknowledged that the three-factor formula has gained wide approval "because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 183 (1983). The Court noted that such formula "can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates." *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965). For the derivation of the "origin of wealth" principle relied on for determining value creation in international tax since the 1920s, see generally Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke L.J.* 1021 (1997).

Figure 1.
2021 State Corporate Income Tax Apportionment Formula



Disclaimer: This information should be used for general guidance and not relied upon for compliance.
Source: Council On State Taxation
* Maryland: single sales factor for tax years after 2022.
** Mississippi: industry specific formulas, with single sales factor if no formula is specified.

In the decades that followed, states have moved gradually but steadily toward assigning an even greater share of taxing rights to market jurisdictions. By 1978, 42 of the 44 states (and the District of Columbia) that imposed a corporate income tax used the three-factor formula adopted by UDITPA and the MTC.[37] By 1994, 17 of these states had switched from a single-weighted to a double-weighted sales factor, thus allocating half of all income to the market states.[38]

Beginning with Iowa in the 1970s, many states went further and began to rely exclusively on a single sales factor that assigned 100 percent of taxing rights to the market state. In 1978 the U.S. Supreme Court affirmed Iowa's use of a single-sales-factor formula in *Moorman Manufacturing Co. v. Bair*.[39] As of 2021, nearly all states with a corporate income tax and the District of Columbia generally use a single-sales-factor formula or a formula with a heavily weighted sales factor, except for Alaska, Hawaii, Kansas, Montana, New Mexico, North Dakota, and Oklahoma (see Figure 1).[40]

The shift to a single sales factor was one of two changes that moved states away from the global tax norm of assigning little or no weight to the market itself. The other change occurred in the sales factor sourcing rules themselves. From the beginning of the development of the UDITPA three-factor formula, sales of tangible personal property were sourced to the state of destination (consumption), thus conforming the sourcing rule with the intent of the sales factor to represent the market jurisdiction.[41] However, the original UDITPA and MTC sales factor method provided a different sourcing rule for "sales, other than tangible personal property" (including services and intangibles), that attributed these sales

[37] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 283 (1978) (Powell, J., dissenting).

[38] Jamie Bernthal et al., "Single Sales-Factor Corporate Income Tax Apportionment: Evaluating Impact in Wisconsin," University of Wisconsin-Madison Workshop in Public Affairs, 18 (May 2012).

[39] *Moorman*, 437 U.S. at 267.

[40] Based on COST research.

[41] UDITPA section 16(a).

receipts to the state where the income-producing activity is performed.[42]

Many states grew dissatisfied with the functionality of UDITPA's cost-of-performance approach because it essentially turned the sales factor for sourcing services and intangibles from its intended market approach to something that mirrored the property and payroll factors. This caused states to move away from UDITPA's cost-of-performance sourcing method to a market-based sourcing approach for services and intangibles. The shift to market sourcing for sales of services and intangibles accelerated over the next few decades, spurred on by the growth of the digital economy. Approximately 32 of the 44 states and the District of Columbia now generally apply a market-based sourcing rule for service receipts and intangibles — a dramatic increase from the four states that used a similar rule just 20 years before.[43]

The State Shift From Physical Presence to Economic Presence Nexus

The state corporate income tax shift from a physical presence to an economic presence standard is a more recent historical development, but still began almost three decades ago. In 1992 the U.S. Supreme Court in *Quill*[44] reaffirmed its position that a state could not require a remote seller to collect sales and use taxes unless the seller had a physical presence in the state. Following the Court's decision, state courts wrestled with whether the physical presence rule applied to state corporate income taxes. A split among state courts emerged, with most state courts finding that *Quill*'s physical presence rule did not extend beyond sales and use taxes. This position gained traction in 1993 in *Geoffrey*,[45] in which the South Carolina Supreme Court held that an out-of-state taxpayer that licensed intangibles used in the state and derived income from their use had substantial nexus with the state and thus was subject to the state's corporate income tax laws. Many other states soon followed *Geoffrey*'s narrowed application of *Quill*.

The shift to economic nexus rules initially focused on businesses that earned income from intangibles (for example, the licensing of trade names or trademarks) or from interstate financial services because of the multijurisdictional nature of these business models, coupled with the lack of an established physical presence. These early trendsetting shifts to economic nexus for state income tax purposes were undertaken for the same reasons that the G-20 and OECD focused on this area 25 years later — concern about the inadequacy of exclusive reliance on a physical presence rule in an economy in which physical presence is no longer necessarily a precondition to earning significant levels of income in a market jurisdiction.

In 2018, in *Wayfair*, a case that received global attention, the U.S. Supreme Court overturned its long-standing physical presence requirement for a state to exercise sales tax jurisdiction on a remote seller and replaced it with an economic presence test.[46] *Wayfair* involved an internet retailer, and the Supreme Court's decision rested on the dramatic changes brought about by digital business models. The *Wayfair* decision, while only applicable to sales and use taxes, also had an immediate impact on the remaining states that had not yet switched to an economic presence test for corporate income taxes. Before *Wayfair*, approximately 15 state courts found that a physical presence was not required for a state to impose its corporate income tax. After the *Wayfair* decision, the shift to economic nexus standards for state corporate income taxes has become universal. Now, all states (and the District of Columbia) with a corporate income tax, except for Delaware, require (or at least do not preclude the use of) an economic nexus standard for all business activity (see Figure 2).[47]

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[42] UDITPA section 17. If the income-producing activity is performed in more than one state, the receipts are attributed to the state in which "a greater proportion of the income producing activity is performed . . . based on costs of performance." UDITPA's three-factor apportionment method and sourcing rules for sales of services and intangibles based on the location of the taxpayer's income-producing activity were also incorporated in the Multistate Tax Compact in 1967.

[43] Based on COST research. *See generally* Frieden and Do, *supra* note 28. *See also* Multistate Tax Compact, Article IV.17(a)(3).

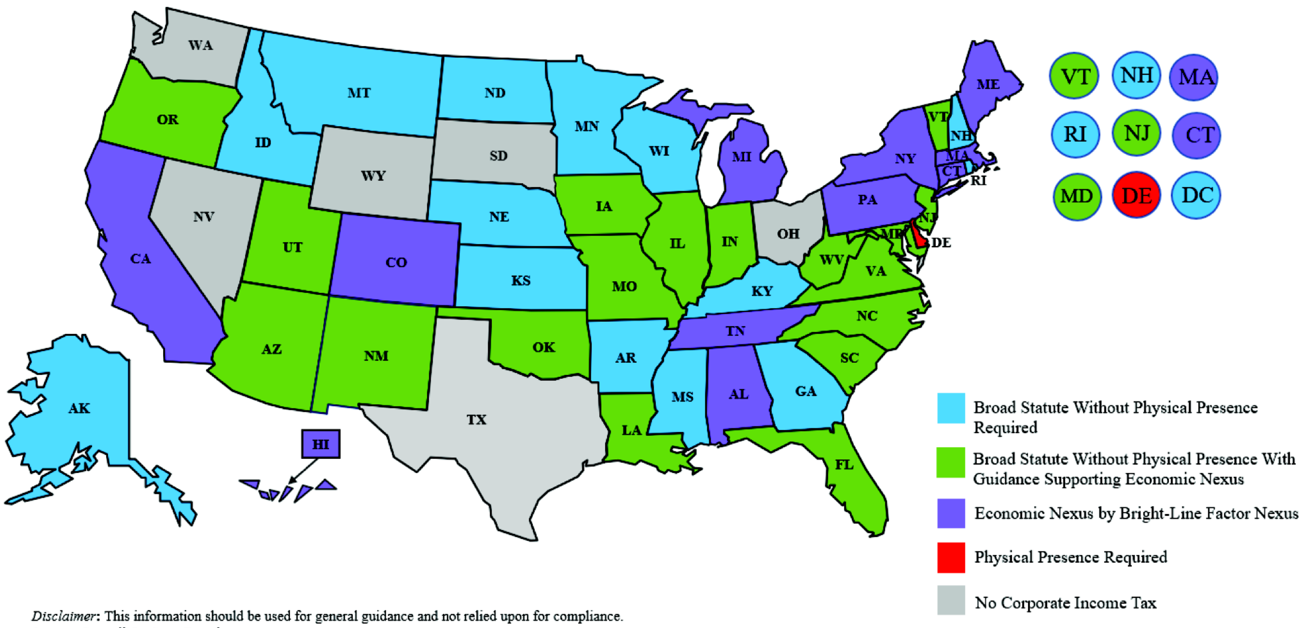
[44] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[45] *Geoffrey Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (1993).

[46] *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018). The physical presence requirement was previously upheld in *National Bellas Hess Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and *Quill*, 504 U.S. at 298.

[47] Based on COST research. The economic nexus standard may be established by broad statutory language, state case law, administrative guidance affirming the application of an economic presence test or the economic substance doctrine, or through a factor presence test to establish corporate income tax nexus. Some states with broad statutory language have offered little to no interpretive guidance on the application of the standard. *See* Frieden and Do, *supra* note 28.

Figure 2.
State Corporate Income Tax Economic Nexus Standard



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Source: Council On State Taxation

The Convergence of Pillar 1 Proposals and State Tax Rules

The convergence between the OECD/G-20 pillar 1 proposals and the state income tax precedents is clear: The pillar 1 rules incorporate the same two principles — economic presence nexus and formulaic market allocation — that the states have long used to adapt corporate income taxes to the expansion of cross-border commerce and digitalization. Many of these state tax changes predate the modern globalization and digitalization of the economy, but they address similar issues in applying corporate income taxes to remote sales, cross-border services, and intangible property transactions. And the pace of state tax changes has accelerated over the past two decades as states have recognized the inadequacies of exclusive use of physical presence and value-creating activity rules to rapidly expanding digital business models.

The July 2021 agreement of inclusive framework jurisdictions indicates the intention to address remaining open issues and develop a detailed implementation plan to finalize pillar 1 by October. The agreement provides that the multilateral instrument for implementation of such rules will be developed and opened for signature in 2022, with the rules coming into effect in 2023. Given all that is still to be done, that timeline seems aspirational.

The implementation phase will require that countries make the changes to their domestic tax laws necessary to incorporate the new rules and do so in a manner that has each country applying the same new nexus standard and formulaic allocation rules in exactly the same manner. Implementation will also require a multilateral instrument to accomplish the necessary amendments to the global network of bilateral tax treaties. Tax authorities will need to have processes in place for preventing and resolving disputes on a multilateral basis. Also, the G-20 and OECD will need to have developed robust peer review mechanisms to ensure that the new rules operate as intended. Given the unprecedented level of coordination and cooperation that will be required among policymakers and tax administrations around the world, it is likely to be several years or more before the new rules developed under pillar 1 take effect.

The pillar 1 approach to economic presence nexus and market allocation is not as far-reaching as the state corporate income tax approach. The OECD/G-20 rules would apply only to the largest global companies based on revenue and profitability, using thresholds of €20 billion and 10 percent. The profit reallocation to market countries would apply only to 20 to 30 percent of the profits above 10 percent. These proposed global rules represent just a toe in the water compared with the states, which are already swimming in the deep end.

Nonetheless, the convergence in terms of tax policy principles is unmistakable. Moreover, this may just mark the beginning of the shift in global tax rules. The July 2021 agreement contemplates the possibility of an expansion in the scope of the pillar 1 rules through a reduction in the revenue threshold to €10 billion after seven years. The European Union has already announced its intention to propose in 2023 a new EU-wide common tax base and system of formulary apportionment.[48] As with the states, the global concepts of economic presence and formulaic market allocation are likely to continue to evolve, and may well apply to a broader set of MNCs and a greater share of profits over time.

Overview of Pillar 2 — New Global Minimum Tax Rules

The system of global minimum tax rules contemplated under pillar 2, like the pillar 1 proposals, would break new policy ground for the OECD and significantly alter the global tax architecture. In contrast to the original BEPS project, pillar 2 does not directly target instances of base erosion and profit-shifting behavior by MNCs. Rather, pillar 2 is aimed more fundamentally at tax competition among countries by creating a global framework under which countries can impose additional tax on low-taxed foreign income of MNCs.

The design of the pillar 2 rules under development through the OECD/G-20 process is inspired by the U.S. GILTI and BEAT provisions enacted with the TCJA, but the specifics of the global and U.S. approaches are quite different. The Biden administration has proposed major changes to both of these TCJA provisions, some of which reflect convergence (and cross-pollination) with elements of pillar 2, and some of which deviate significantly from the pillar 2 approach. Looking ahead to implementation of pillar 2 rules by individual countries, it is likely that there will be some — indeed, potentially quite substantial — variation in how the global minimum tax rules as agreed are ultimately transposed into the domestic laws of each country that chooses to adopt them.

The Design of Pillar 2

The basic approach under pillar 2 is a set of rules that would allow a country that has a connection to business income earned in a low-tax country to impose tax on that income in order to top up the source country tax so that the combined tax imposed on the income reflects the globally agreed minimum rate of tax. A prioritization of the rules identifies the country that would have the primary right to impose the top-up tax as well as the country or countries that would have secondary rights to impose such tax in the event that the country with the primary taxing right does not exercise its right. At the insistence of developing countries participating in the inclusive framework, pillar 2 would also allow countries to apply increased gross-basis withholding taxes on certain outbound payments made to affiliates in low-tax countries.

Under the pillar 2 blueprint released in October 2020, the core minimum tax mechanism is the global anti-base-erosion rules, with the income inclusion rule (IIR) as primary and the undertaxed payments rule (UTPR) as secondary. The IIR would give countries the primary right to impose minimum tax on the foreign profits of their own MNCs. The IIR operates using a mechanism similar to controlled foreign company rules, with the home country of the MNC group parent collecting top-up tax based on the parent's direct or indirect ownership of any group entities that have an effective tax rate (ETR) below the agreed minimum rate. The IIR applies under a

[48] European Commission, "Communication From the Commission to the European Parliament and the Council: Business Taxation for the 21st Century," section 4 on Business in Europe: Framework for Income Taxation (BEFIT) and Action 5 (May 18, 2021).

top-down approach, giving the right to impose tax first to the jurisdiction of the group parent and then cascading that right down the chain of intermediate owners if the home countries of the group parent and upper-tier owners have not implemented an IIR.

The pillar 2 blueprint provides that the secondary taxing rights under the UTPR would apply only where no IIR is applicable. The focus of the UTPR is on deductible cross-border payments to related parties. The UTPR would apply to any low-ETR entity in an MNC group that is not subject to an IIR applied by the home country of the group parent or of an intermediate parent entity. The taxing rights under the UTPR are calculated based on the top-up tax that could have been imposed under an IIR. The UTPR also would apply to the group parent itself if it has an ETR below the agreed minimum rate. The blueprint lays out a detailed set of rules for allocating the taxing rights under the UTPR first to the home countries of any group entities that make deductible payments to the low-ETR entity, and then to the home countries of other group entities in UTPR jurisdictions that have net intragroup expenditures. However, the July 2021 agreement of inclusive framework jurisdictions states only that the taxing rights under the UTPR will be allocated under a method to be agreed upon, which suggests that the complex approach reflected in the blueprint may be reconsidered. The blueprint provides that the UTPR taxing rights allocated to any country would be exercised through a domestic law mechanism determined by the country, which could be a denial or limitation of deductions for intragroup payments or an additional tax. The July 2021 agreement notes the possibility of a transition approach that defers implementation of the UTPR.

In addition to the IIR and UTPR, the pillar 2 blueprint includes a treaty-based rule that allows for increased withholding taxes. Like the UTPR, this subject-to-tax rule (STTR) would provide additional taxing rights to countries from which certain deductible payments are made to low-taxed affiliates. However, because it would not require an ETR determination and it would be collected through withholding imposed by the payor at the time the payment is made, the STTR is considered by developing countries as far simpler to apply than the UTPR. The blueprint provides that tax paid under an STTR would be included in the ETR calculation for purposes of determining the applicability of an IIR or UTPR. Thus, the STTR effectively would take precedence over both the primary IIR and the secondary UTPR.

As confirmed in the July 2021 agreement, the IIR and UTPR would apply to MNCs that meet the consolidated group revenue threshold of €750 million that applies for purposes of the CbC reporting requirements established under BEPS action 13.[49] The blueprint contemplates the use of a materiality threshold for application of the STTR, but the design of such a threshold has not yet been determined.[50]

The pillar 2 blueprint includes rules for determining the income that would be subject to the global minimum tax rules, with the IIR and UTPR applying to a broad base with targeted exclusions for specific categories of income.[51] The tax base for IIR/UTPR is computed using financial accounting income rather than taxable income.[52] The July 2021 agreement provides specifics for a formulaic substance-based carveout excluding an amount of income that would be at least 5 percent of the carrying value of tangible assets and payroll (with a higher rate that would be at least 7.5 percent applicable for an initial five-year

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[49]Specified investment-type entities at the top of an MNC group, including investment funds, pension funds, and nonprofit organizations, would not be subject to these rules. The July 2021 agreement also indicates the intention to explore the possibility of a further exclusion for MNCs that are in the initial phase of their international activity.

[50]Potential options noted in the blueprint include basing the threshold on MNC group size (such as the scope rule for the IIR and UTPR), on the amount of covered payments (such as a specified minimum level of covered payments or a specified ratio of covered payments to total expenditures), or on some combination of these approaches.

[51]In contrast to the IIR and UTPR, the STTR would apply only to specific categories of outbound payments, which the July 2021 agreement describes as interest, royalties, and a defined set of other payments.

[52]The starting point for the tax base would be the financial accounts for the MNC group entities that are resident in a jurisdiction, determined based on the accounting standard used by the group parent in its consolidated financial statements. Some adjustments to financial accounting income would be made to avoid duplication or address permanent differences. The pillar 2 blueprint also provides that a mechanism will be developed to preserve the benefits of immediate expensing or accelerated depreciation for local tax purposes.

transition period).[53] The blueprint also provides mechanisms for the carry forward of losses and specific taxes to prevent overtaxation under the IIR and UTPR, while the July 2021 agreement refers more broadly to mechanisms to address timing differences.

The pillar 2 blueprint provides that the IIR and UTPR both would be computed on a per-country basis and would reflect the additional tax necessary to bring the ETR on in-scope income earned in a low-tax country up to the agreed minimum rate. The ETR would take into account all income taxes imposed on income earned in the country.[54]

The pillar 2 blueprint did not include any information regarding the tax rate that might be set as the minimum rate for the IIR and the UTPR. Until recently, speculation had centered on a minimum rate in the 12.5 percent range, consistent with the Irish tax rate. In May the U.S. Treasury Department released a statement indicating that during inclusive framework discussions regarding pillar 2, it had proposed that "the global minimum tax rate should be at least 15 percent," emphasizing that "15 percent is a floor and that discussions should continue to be ambitious and push that rate higher."[55] The G-7 finance ministers committed to a minimum tax rate of at least 15 percent in June. The July 2021 agreement among members of the inclusive framework specifies that the minimum tax rate used for purposes of the IIR will be at least 15 percent.[56] The precise rate to be set as the minimum tax rate is an open question that remains to be addressed in the final agreement expected in October.

To illustrate the application of the top-up tax under the IIR and UTPR, assume an agreed minimum tax rate of 15 percent and consider an MNC headquartered in country X with subsidiaries in countries Y and Z. As computed under the pillar 2 rules, the country Y subsidiary has in-scope income of $100 million and an ETR of 10 percent, and the country Z subsidiary has income of $50 million and an ETR of 18 percent. The top-up tax under a country X IIR would be $5 million (the excess of the 15 percent minimum rate over the 10 percent ETR applied to $100 million of income). If country X does not have an IIR, but country Z has a UTPR and the country Z subsidiary makes deductible payments to the country Y subsidiary, country Z could impose tax under the UTPR of up to $5 million (subject to a cap based on the amount of deductible payments made from the country Z subsidiary to the country Y subsidiary and the country Z tax rate).

Finally, as the July 2021 agreement spells out, there is no requirement for inclusive framework member jurisdictions to adopt the global anti-base-erosion rules. Such rules merely constitute a "common approach." If inclusive framework jurisdictions choose to adopt the IIR and UTPR, they agree to implement them in a manner consistent with the pillar 2 agreed design, and they accept the application of these rules by other member jurisdictions.[57]

Altering the Global Tax Architecture

Pillar 2 is sometimes described as requiring countries around the world to adopt at least a minimum corporate tax rate. However, that is not accurate. The approach of pillar 2 is not to mandate that any country change its corporate tax rate. Rather, the approach is to provide interested countries with tools to counter the low taxes in those countries that choose to impose a corporate income tax at a rate below the agreed minimum

[53] The precise rate to be set for this exclusion (as well as the higher rate for the transition period) is an open question that remains to be addressed in the final agreement. The July 2021 agreement provides an exclusion for international shipping income, and it indicates that a de minimis exclusion is to be provided but does not include any details.

[54] Income taxes that are imposed by another country, such as withholding taxes and tax under a controlled foreign company regime, would be included in the ETR for the jurisdiction where the income is earned. Taxes paid on income allocated to a country under pillar 1 would be included in the ETR, as would income taxes imposed at the state and local level. DSTs would not be included in the ETR, nor would other non-income taxes.

[55] U.S. Department of the Treasury, "Readout: U.S. Department of the Treasury's Office of Tax Policy Meetings" (May 20, 2021).

[56] The July 2021 agreement also specifies that the minimum rate for the STTR will be from 7.5 to 9 percent and provides that the taxing right under the STTR will be limited to the difference between the minimum rate and the tax rate on the payment. The precise rate to be set as the STTR minimum rate remains to be addressed in the final agreement.

[57] Regarding the STTR, the July 2021 agreement provides a higher standard, indicating that inclusive framework jurisdictions that apply nominal tax rates below the STTR minimum rate to the covered categories of payments agree to incorporate the STTR into a bilateral tax treaty if they are asked to do so by a developing country in the inclusive framework.

rate. The inclusive framework described pillar 2 this way in October 2020:

> We acknowledge that jurisdictions are free to determine their own tax systems, including whether they have a corporate income tax and the level of their tax rates, but also consider the right of other jurisdictions to apply an internationally agreed pillar 2 regime where income is taxed below an agreed minimum rate.[58]

While it is clear that no country would be required to change its corporate tax rate based on pillar 2, it is equally clear that one of the intended effects of pillar 2 is that it may well drive countries to consider raising their tax rates to the agreed minimum rate. If business income earned in a low-tax country is subject to additional tax in another country under pillar 2, the business activity or investment that the low-tax country seeks to attract with its low tax rate would no longer benefit from such rate, and the other country would reap a windfall from the top-up tax it imposes on such income. These two factors could create a strong incentive for the low-tax country to adopt the agreed minimum rate in lieu of seeing the low taxes it imposes on income earned within its jurisdiction topped up by other countries that pocket the revenue generated with such additional taxes.

U.S. Treasury Secretary Janet Yellen referred to this aspect of pillar 2 following the June 2021 G-7 Finance Ministers meeting:

> The agreement under pillar 2 contains an enforcement mechanism that would come into play and apply to jurisdictions that decide, "no we're happy to be tax havens, and we don't want to sign up to this agreement." . . . So, I think this is an agreement that when you understand all the details, you would see that it doesn't require absolute agreement across the board. It has a way of bringing holdouts into it.[59]

[58]OECD/G-20 inclusive framework, *supra* note 15.

[59]U.S. Department of the Treasury, "Transcript of Press Conference by Secretary of the Treasury Janet L. Yellen Following the Close of the G-7 Finance Ministers Meetings" (June 5, 2021).

Despite not being mandatory, pillar 2 could significantly alter the existing global tax architecture. Countries have never before joined together to establish a global floor on the corporate income tax rate for cross-border commerce through a coordinated framework of additional taxing rights that can be exercised over foreign income. To be sure, home countries do in some instances tax foreign income of their MNCs that may be subject to lower tax in the source country. This includes taxation under controlled foreign company rules of specific categories of "passive income" when it is earned in the foreign country[60] or taxation of a wider range of foreign business income when it is distributed in the form of intercompany dividends. However, controlled foreign company rules have limited reach, and the taxation of foreign dividends has declined dramatically in recent years as most countries have moved to dividend exemption systems.[61] Moreover, work in the OECD on bilateral income tax treaties historically has focused on providing for reductions in gross-basis withholding taxes, in contrast to the STTR's allowance of increased withholding taxes.

U.S. Federal Precedents and Pillar 2 Cross-Pollination

While the concept of minimum tax rules predates the original BEPS project,[62] it did not become a focus of the OECD/G-20 initiative until the enactment of the TCJA in the United States in 2017. Two provisions in the TCJA — the GILTI and BEAT rules — formed the basis for the pillar 2 approach to global minimum taxes.

While there are significant differences between the elements in the pillar 2 IIR and the U.S. GILTI provision, the conceptual similarities

[60]For historical information on the development and enactment in 1962 of the U.S. rules imposing tax on some undistributed earnings of foreign subsidiaries of U.S. MNCs, see U.S. Treasury Office of Tax Policy, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study" (Dec. 2000).

[61]Over the last three decades, most OECD countries have shifted toward territorial tax systems and away from "worldwide" systems. *See* Kyle Pomerleau, Daniel Bunn, and Thomas Locher, "Anti-Base Erosion Provisions and Territorial Tax Systems in OECD Countries," Tax Foundation, Fiscal Fact No. 772 (July 2021).

[62]The concept of taxing some foreign income of U.S. MNCs on a current basis at a reduced rate of tax was part of tax reform discussions in the United States beginning in 2011 and was included in the tax reform discussion draft released by the then-chair of the House Ways and Means Committee on February 26, 2014.

are striking. Both provisions provide the headquarters country with the right to impose tax on the foreign income of its MNCs, but only at a specified minimum tax rate. The Biden administration has proposed significant changes to the current-law GILTI provision, including a fundamental change that aligns with the per-country application of the IIR.[63] At the same time, other aspects of the proposed changes would move the GILTI provision well beyond the pillar 2 IIR in terms of tax imposed.

In this regard, whether the GILTI rules would be treated as a qualifying IIR is an important question. Under the pillar 2 design, application of a qualifying IIR to low-taxed foreign income would preclude any application of another country's UTPR to such income. The October 2020 pillar 2 blueprint includes a discussion of GILTI coexistence that indicates that there was a willingness to treat the current-law GILTI rules as a qualifying IIR despite the deviations between its design and the pillar 2 design in recognition that it was the "original IIR." While the July 2021 agreement also refers to GILTI coexistence, it is not as clear about the potential for treatment of the GILTI rules without modification as a qualifying IIR. In the absence of such treatment, a U.S. MNC that is subject to the GILTI rules could also be subject to another country's UTPR.[64]

Although the U.S. BEAT provision served as an inspiration for the pillar 2 UTPR, the only real commonality is that both the BEAT and UTPR focus on deductible cross-border payments to related parties. The mechanism of the BEAT provision is an alternative tax calculation that yields an additional tax amount to be added to the tax calculated under regular U.S. tax rules for an increased total U.S. tax liability. The BEAT broadly operates as a 10 percent tax on specific deductible payments to foreign related parties, but it applies without regard to the level of tax imposed on the payment in the recipient's home country, so it does not function as a minimum tax. However, the Biden administration has proposed replacing the BEAT provision with a new provision that clearly is broadly inspired by the pillar 2 UTPR. Like the UTPR design, the Biden administration's proposed stopping harmful inversions and ending low-tax developments (SHIELD) provision would disallow deductions to U.S. corporations for payments made or deemed made to low-taxed affiliates.[65] As with the proposed GILTI provision changes and the pillar 2 IIR, the proposed SHIELD provision would go well beyond the pillar 2 UTPR in terms of tax imposed.

The cross-pollination between the pillar 2 global minimum tax proposals and the U.S. rules and proposals can be viewed through the prism of two core elements: the income base for the minimum tax and the amount of tax imposed under the minimum rate.

Minimum Tax Base

Consistent with pillar 2, the tax base for the GILTI provision generally is all income of foreign subsidiaries in an MNC group that is U.S. headquartered, with some limited exclusions.[66] A carveout is provided for a deemed return of 10 percent on each foreign subsidiary's qualified business asset investment. QBAI is measured based on the adjusted basis of specified tangible property used in the production of income. QBAI does not include payroll costs, which are part of the proposed pillar 2 substance-based carveout. More significantly, the pending Biden administration proposal for modifying the GILTI rules would eliminate the QBAI carveout, which would lead to a minimum tax base under the U.S. rules as amended that would be larger than the tax base under the corresponding pillar 2 proposal.

Another point of differentiation between the tax bases of pillar 2 and GILTI is the treatment of losses and timing differences. Under pillar 2, loss carryforward rules and mechanisms to address timing differences are provided to ensure that the

[63] Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (May 2021).

[64] Note that because the STTR takes precedence over both the IIR and UTPR, U.S. MNCs could be subject to tax imposed by another country under the STTR without regard to the treatment of the GILTI provision as a qualifying IIR.

[65] *Supra* note 63.

[66] Note, however, that while the pillar 2 IIR would apply only to MNC groups that meet a €750 million revenue threshold, the U.S. GILTI rules apply to U.S.-headquartered MNC groups (or to the subgroup below an intermediate U.S. holding company in a foreign-headquartered group) without regard to the size of the group or subgroup. The Biden administration's proposed amendments to the GILTI rules would not introduce any scope restriction.

application of minimum tax rules does not effectively result in the overtaxation of income over time. The GILTI provision under current law and as proposed to be expanded has no similar mechanisms, with the GILTI rules operating on a year-by-year basis.

Under pillar 2, the same approach for measuring low-taxed foreign income is used for both the IIR and the UTPR, with the two rules simply using different approaches for assigning the taxing rights relating to the top-up tax. While all the details of the proposed SHIELD rules are not fully spelled out, the proposal reflects a broadly similar approach for measuring the low-taxed foreign income of an MNC group in order to determine the group's ETR in a country, except that it does not provide for a substance-based carveout.[67]

Minimum Tax Rate

Under the traditional international tax architecture, when a country imposes tax on the earnings of foreign affiliates in an MNC group, typically only passive-type income is taxed on a current basis, and other earnings are taxed only when distributed as an intercompany dividend, with such amounts subject to the full domestic corporate tax rate and relief from double taxation through a foreign tax credit or other mechanism. The GILTI rules and the pillar 2 rules both take a different approach by providing countries with the right to impose tax on all low-taxed income of foreign affiliates on a current basis, but only up to a specified minimum tax rate.

Under the GILTI rules, the income inclusion is computed by looking at the income of a U.S. MNC's foreign subsidiaries in the aggregate, which has the effect of blending higher-tax and lower-tax foreign income in a way that reduces the potential U.S. tax liability. This is in contrast to the proposed IIR mechanism, under which the parent company's inclusion of income earned by a foreign subsidiary is calculated on a per-country basis. The Biden administration's proposed modifications to the GILTI rules would replace its global determination with a per-country determination, eliminating the blending across jurisdictions that occurs under the current-law GILTI provision and instead isolating income by country, which would increase the potential tax under the GILTI provision while bringing it into closer alignment with the proposed design of the pillar 2 IIR.

Under current law, the GILTI inclusion is subject to a reduced level of U.S. tax, which is accomplished through a deduction for half the otherwise includable amount. This yields U.S. tax at a 10.5 percent rate instead of the regular 21 percent corporate tax rate.[68] Under the GILTI provision, the credit for foreign taxes that reduces the U.S. tax liability on GILTI income is subject to a 20 percent haircut. Taking into account the effect of the FTC haircut has the potential to increase the tax on GILTI.[69]

The pending Biden administration proposal to modify the GILTI rules includes a significant increase in the tax rate under the GILTI provision. The proposals would reduce the deduction regarding the GILTI income inclusion from 50 percent to 25 percent, which when combined with the Biden administration's proposal to increase the U.S. corporate tax rate to 28 percent would yield an effective U.S. corporate tax rate of 21 percent under GILTI (and potentially higher if the FTC haircut and the treatment of expenses are factored in).[70] While the July 2021 agreement provides that the minimum tax rate under pillar 2 will be *at least* 15 percent, it is unlikely that the final agreed pillar 2 minimum tax rate will be as high as the currently proposed GILTI rate.

The Biden administration's SHIELD proposal generally would match the agreed pillar 2 minimum tax rate but would use a rate that matches the GILTI tax rate if the SHIELD rules are in effect before there is a pillar 2 agreement. However, under the SHIELD design, the designated minimum tax rate would be used only

[67]Note also that the Biden administration's proposed SHIELD provision would apply to consolidated groups with more than $500 million in global annual revenues, which is lower than the €750 million threshold that applies to the pillar 2 UTPR.

[68]For tax years beginning after 2025, the deduction for GILTI is scheduled to decrease from 50 percent to 37.5 percent of the otherwise includable amount, which will yield U.S. tax at a 13.125 percent rate.

[69]The haircut can drive the combined foreign and GILTI tax rate up to 13.125 percent (and 16.406 percent after 2025). Expense allocation rules in the United States further exacerbate this effect.

[70]The proposal does not include any change to the FTC haircut under the GILTI provision. Moreover, the proposal includes a deduction denial for expenses allocable to exempt income, which would further increase the tax under the GILTI provision.

for purposes of identifying low-taxed foreign affiliates and would not function as a cap on the tax that could be imposed under SHIELD. Unlike the pillar 2 UTPR, the proposed SHIELD provision does not operate through a top-up tax mechanism that caps the taxing rights based on the difference between the foreign ETR and the minimum tax rate. Therefore, the tax under the SHIELD deduction disallowance could far exceed the amount of the minimum-rate-based top-up tax that would be imposed under the pillar 2 UTPR. This aspect of the SHIELD proposal is intended to encourage other countries to put in place IIRs, which would take precedence over the SHIELD for their own MNCs.[71]

The Convergence of U.S. Federal Concepts and Pillar 2 Proposals

The convergence between the pillar 2 approach and the U.S. GILTI and BEAT/SHIELD approaches is clear. The pillar 2 and U.S. approaches are based on the same two principles: (1) a global minimum top-up tax that applies to a country's own MNCs operating in low-tax jurisdictions, and (2) a disallowance of deductions for outbound low-taxed related-party payments. Together, these new minimum tax rules would transform the international tax architecture with the goal of limiting low-tax-rate competition on a global basis. Furthermore, as with pillar 1, these changes may be just the first step, with the potential for countries to look to increase the level of minimum taxes in the future to further limit global tax rate competition.

There is also a convergence here with U.S. state corporate income tax adoption of GILTI. Since the enactment of the TCJA, 20 of 44 states (and the District of Columbia) with corporate income taxes have included part of GILTI in their corporate income tax base. They have done so with a variety of income inclusion percentages and apportionment formulas. However, the effect at the state level of including foreign income in the tax base often diverges significantly from the federal or global approaches (see more detailed discussion in Part 2).

[71]*Supra* note 63.

The July 2021 agreement of the inclusive framework jurisdictions anticipates a final decision on key design elements by October. It contemplates that pillar 2 rules should be brought into law in 2022 to be effective in 2023. In this regard, it is important to remember that there is no requirement that inclusive framework jurisdictions implement the pillar 2 rules, which increases the likelihood that implementation through changes in domestic tax law will play out around the world over an extended period. Moreover, the U.S. legislative process involving the Biden administration's tax proposals, including the proposed changes to the GILTI provision and the proposed adoption of the new SHIELD provision, will likely play out before any other country has implemented pillar 2 rules.

Part 2: The Divergence of Global, Federal, and State Tax Policies

Introduction

In Part 1, we highlighted the historic convergence of international and U.S. federal and state corporate income taxes. For U.S. tax policy, there are potential benefits from the OECD/G-20 pillar 1 and 2 proposals. Pillar 1 could lead to the elimination of unilateral measures such as DSTs that discriminate against U.S. MNCs. With pillar 2, there is the potential for a widespread system of a global minimum tax rules that could create a more level tax playing field between nations. If properly designed and implemented, convergence in global tax rules could provide benefits for both governments and businesses.

The potential convergence of corporate income tax rules, however, should not obscure the risk of divergence between the global and U.S. approaches on significant elements of the new rules. In Part 2 of this article, we look at some of the risk factors through the prism of the aggregate U.S. federal and state tax system as applied to business income. This is particularly important given both the uniquely large state and local government share of all taxes in the United States and the shortcomings of treating federal and state taxes as two separate and disconnected spheres.

When viewed as one integrated fiscal system, the risk of the United States ending up outside global tax norms becomes more apparent. Among the fault lines are the potential that the United States could impose a higher combined federal/state tax on domestic corporate income and distributions than most other nations; impose a higher combined federal/state minimum tax on foreign income of U.S. MNCs than other countries do on their own MNCs; and unilaterally enact DSTs at the subnational level while other nations remove their DSTs enacted at the national level. Importantly, tax rate and base disparity could result in a competitive disadvantage for U.S. MNCs in an increasingly interconnected global economy.

Divergence presents not just short-term risks, but long-term systemic risks as well. The potential for tax rate disparity is reinforced by the unique composition of taxes in the United States, with less reliance on consumption taxes and more reliance on income, social insurance (payroll), and property taxes than any other advanced nation. In particular, as the only country in the world without a general consumption tax at the national level, the United States is dependent on income and social insurance taxes to pay for new federal government programs or reduce federal debt.

The Unique and Interconnected U.S. Federal and State Tax System

To fully appreciate the potential divergence between U.S. and global taxes in both rates and composition, it is necessary to frame the analysis in terms of aggregate federal- and state-level taxes. The United States is not the only country in the world with a federalist fiscal system characterized by large and vibrant subnational governments, but it is certainly one of a small minority of such countries, and by far the most substantial in GDP terms.

The importance of state and local taxes to the overall level and composition of taxes in the United States can be highlighted with a few global comparisons. Among the OECD countries that make up about half of the world's gross domestic product, the United States is one of only 10 countries with a federalist system of government.[72] The United States collects a larger share of revenues at both the state and local levels than do almost all other OECD countries with sizable subnational governments. In 2019 state governments in the United States accounted for 20.8 percent of total government revenues, compared with the average of 16 percent in the other OECD federalist countries.[73] Local governments in the United States accounted for 15.1 percent of all government revenues, compared with 8.4 percent in the other OECD federalist countries.[74] The United States is one of only three OECD countries in which state governments account for one-fifth or more of all government revenues, and state and local governments combined account for one-third or more of all government revenues.[75]

The unique brand of U.S. federalism stands out when the OECD comparison group is broadened to include the G-20 countries. Together, the countries in the OECD or G-20 represent over 90 percent of global GDP. The United States is one of only six of the OECD/G-20 countries that have a corporate income tax at the state level; it is the only one of these countries that currently imposes a state corporate income tax on foreign-source income (see Figure 3).[76]

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[72] OECD, "Revenue Statistics 2019," at tbl. 3.15 (2019).

[73] Cristina Enache, "Sources of Tax Revenue: U.S. vs. OECD," Tax Foundation, at 9 (Feb. 17, 2021).

[74] *Id.*

[75] *Id.* The other two OECD countries with large subnational governments are Canada and Switzerland. Revenue Statistics 2019, *supra* note 72, at tbl. 3.15.

[76] State Tax Research Institute, "Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income," prepared by PwC (Nov. 2019). The other five countries with a state/provincial corporate income tax are Canada, Germany, Italy, Portugal, and Switzerland. Three other countries have municipal-level corporate income taxes (Japan, Luxembourg, and South Korea). Several countries tax "passive" foreign income at the subnational level, but only the United States taxes "active" foreign income at the state level. *Id.*

Figure 3.
The United States Is an Outlier Among the OECD and G-20 Nations From a Subnational Tax Perspective

OECD/G20 Nations With Subnational Corporate Income Tax	OECD/G20 Nations With State Level CIT on Foreign Source Income	OECD/G20 Nations With Subnational Tax on General Consumption	OECD/G20 Nations With Primary Tax on General Consumption at the Subnational Level	OECD/G20 Nations With a Subnational Digital Services Tax	OECD/G20 Nations With the Share of Consumption Taxes as Percent of All Taxes at Less than 20%
United States	United States	United States	United States	United States	United States
Canada		India			
Germany		Brazil			
Italy		Argentina			
Japan		Canada			
Luxembourg					
Portugal					
South Korea					
Switzerland					

Source: Council On State Taxation

Also, the United States is one of only five of the OECD/G-20 countries with a significant subnational consumption tax, and the only advanced nation in the world with its primary consumption tax (the state retail sales tax) at the subnational level. Conversely, the United States is the only country in the world without a broad-based consumption tax at the central/federal government level.[77] These factors combine to create a significant divergence in the overall composition of taxes as the United States relies less on consumption taxes than any other advanced nation in the world.[78] (See Figure 3.)

Finally, the United States is one of only two of the OECD/G-20 countries with both a significant state-level income tax and consumption tax (Canada is the other one), and the only country with a subnational DST.[79] (See Figure 3.)

The importance of subnational government in the United States is accentuated by the nation's influence in the global economy. The United States, with only about 5 percent of the world's population, accounts for about 24 percent of global GDP.[80] This means that the most populous U.S. states, on a stand-alone basis, are major players in the global economy. For instance, California, the nation's most populous state, is so large with its $3.2 trillion gross state product (in 2019) that if treated as a sovereign nation, it ranks as the world's fifth largest economy, ahead of India and behind Germany. Indeed, the other five largest states from a GDP perspective — Texas, New York, Florida, Illinois, and Pennsylvania — all would be on the list of the top 20 nations in the world in GDP on a stand-alone basis if categorized as countries.[81]

[77] Argentina, Brazil, and Canada levy subnational consumption taxes with tax bases separate from the national VAT/goods and services tax. India imposes a subnational consumption tax with the same tax base as the national tax. All four countries have the primary general consumption tax at the national level. EY, Worldwide VAT, GST, and Sales Tax Guide 2020.

[78] The United States relies less on consumption taxes than the 100 nations tracked in the OECD database. OECD Global Revenue Statistics Database, chart of taxes on goods and services as a percent of all taxes for 2019.

[79] State Tax Research Institute, *supra* note 76 (on corporate income tax). EY, *supra* note 77 (on consumption tax). All the DSTs outside the United States are at the national level. EY, *supra* note 26.

[80] *See* Wikipedia, "List of countries by GDP (nominal)."

[81] On state GDP, see Wikipedia, "List of states and territories of the United States by GDP." On country GDP, *see* Wikipedia, *supra* note 80.

The United States not only has a uniquely large subnational tax system by international standards, but the design and administration of federal and state tax systems are intertwined. Aside from state sales tax systems, all other taxes widely imposed at the state level — the personal income tax, the corporate income tax, unemployment insurance taxes, and the estate tax — piggyback on similar federal taxes as a starting point.[82] In fact, federalism is often more efficient when states can start with a uniform federal design and adjust as needed for local political and economic factors.[83]

State and local governments are important to the U.S. fiscal system as independent sources of revenue, but at the same time are dependent on federal financing for a large share of their funding. In recent years, state governments received about 31 percent of their revenues from the federal government, and state and local governments together received about 23 percent of their revenue from the federal government.[84] The level of direct and indirect federal assistance to state and local governments increased substantially during the COVID-19 pandemic as the federal government spent close to $5.5 trillion on pandemic relief and fiscal stimulus.[85]

Federal Tax Policy Generally Ignores the Impact of State Taxes

While state-level taxes are generally modeled after and closely linked to federal government taxes, when it comes to major federal tax reforms, the impact on state taxes is rarely a focus. For instance, the Made in America Tax Plan, the Biden administration's corporate tax plan released in April, makes no reference to the impact of state corporate income taxes on U.S. tax revenues and policies.[86] Similarly, Biden's American Families Plan, the second set of federal tax proposals issued in April, focused primarily on increases in personal income taxes and capital gains taxes on high-income households, makes no mention of the additional tax imposed by personal income taxes at the state level.[87]

This is not a historical aberration, but the norm. When the TCJA was enacted in 2017, there was no focus on the impact of federal tax reform at the state level.[88] In fact, this federal legislation, aimed at reducing the corporate tax (by a net 10 percent), resulted in a substantial corporate tax increase at the state level (about 12 percent).[89] This is because states typically adopt the federal base-broadening provisions but not any changes to federal tax rates (as the states have their own rate structures). Indeed, federal tax reform typically results in corporate tax increases at the state level, regardless of the revenue impact at the federal level.[90] This is also evident with international tax policy, where the states have historically been excluded from bilateral treaties and are not part of design discussions regarding the global international tax architecture. The lack of coordination between U.S. federal and state tax policy is particularly significant given the scale of the U.S. subnational system relative to other nations.

There are other ways in which federal interest in or oversight of state taxes is rare. The U.S. Congress has the authority under the U.S. Constitution's commerce clause to regulate interstate commerce, including imposing constraints on state taxation. However, this authority is infrequently used. Over the last 50 years, there have been only a few instances of wide-scale federal preemption, such as P.L. 86-272 (in

[82] *See* Frieden and Douglas L. Lindholm, "U.S. State Sales Tax Systems: Inefficient, Ineffective, and Obsolete," *Tax Notes State*, Nov. 30, 2020, p. 895.

[83] For instance, both state corporate and personal income taxes were enacted with provisions conforming significantly to federal concepts of income, deductions, and exemptions. However, states have made modifications based on state-specific considerations such as tax rates, tax base adjustments, treatment of foreign-source income, income apportionment, and tax credits. While states zealously guard their sovereignty over subnational taxes, the similarities between the federal and state income tax bases are still far more pervasive than the differences.

[84] Center on Budget and Policy Priorities, "Policy Basics: Federal Aid to State and Local Governments"(Apr. 19, 2018).

[85] Committee for a Responsible Federal Budget (CRFB), "New Budget Projections Show Record Deficits and Debt" (Mar. 11, 2021).

[86] *See* U.S. Treasury, "The Made in America Tax Plan" (Apr. 7, 2021).

[87] *See* White House, "Fact Sheet: The American Families Plan" (Apr. 28, 2021).

[88] The only federal/state issue that received considerable attention was a tangential one — the $10,000 cap on federal deductions for state and local taxes imposed by the TCJA.

[89] Andrew Phillips and Steve Wlodychak, "The Impact of Federal Tax Reform on State Corporate Income Taxes," EY report prepared for the State Tax Research Institute (Mar. 2018).

[90] The corporate tax increase in the Tax Reform Act of 1986, the corporate tax reduction in the TCJA in 2017, and the corporate tax increases proposed by the Biden administration in the Made in America Tax Plan in 2021 all did (or would) result in corporate tax increases at the state level.

1959) preventing a state from imposing a corporate income tax when a business's contacts with a state are limited to solicitation of sales, and the Internet Tax Freedom Act (in 1998) precluding a state from imposing sales tax on internet access or discriminating against e-commerce.[91]

Much more common is federal inaction, even when the states might welcome limits on their sovereignty. For instance, over a 25-year period, the U.S. Congress declined to intervene, despite the urging of the U.S. Supreme Court (in *Quill*[92]), to mandate more uniform and simplified state sales tax administration rules. In that instance, federal harmonization of state rules could have resulted in a significant increase in state and local tax revenues, as it would have removed the commerce clause's prohibition on state imposition of a sales tax collection responsibility on remote sellers without physical presence in the customer's state.

The federal government's disinclination to consider state and local tax impacts related to federal tax reform frequently serves both federal and state interests. The federal government can craft significant tax policy changes without weighing cumbersome and complex interactions with state tax rates and tax bases. The state governments generally retain highly valued sovereignty over their own fiscal affairs. However, what is in the self-interest of the federal and state governments on a stand-alone basis is not necessarily good for national tax policy on the global stage.

The global and federal tax changes under consideration in 2021 constitute a turning point for U.S. federalism, significantly increasing the costs of not taking into account aggregate federal and state tax levels and tax composition. If state tax policies are not considered as a part of these changes, it could exacerbate harmful economic outcomes, including competitive rate disadvantages for U.S. MNCs relating to both domestic and foreign income; competitive barriers to foreign investment in the United States; the adoption of DSTs at the state level contrary to the federal policy objections to DSTs; and imbalance in the composition of U.S. taxes, with the heavy reliance on income taxes, particularly at the federal level.

The Divergence in Tax Rates on Corporate Income and Distributions

A key aspect of the emerging global tax architecture is the potential for broader tax rate parity among nations. Countries have always set their own tax rates, independent of any multilateral activity. Tax rate autonomy will continue, but pressure is building in connection with global minimum taxes on foreign income that could result in greater parity. From a country's perspective, parity is important both to establish a reasonable floor to limit low-tax-rate competition and to ensure that the country's own top marginal tax rates do not create competitive disadvantages.

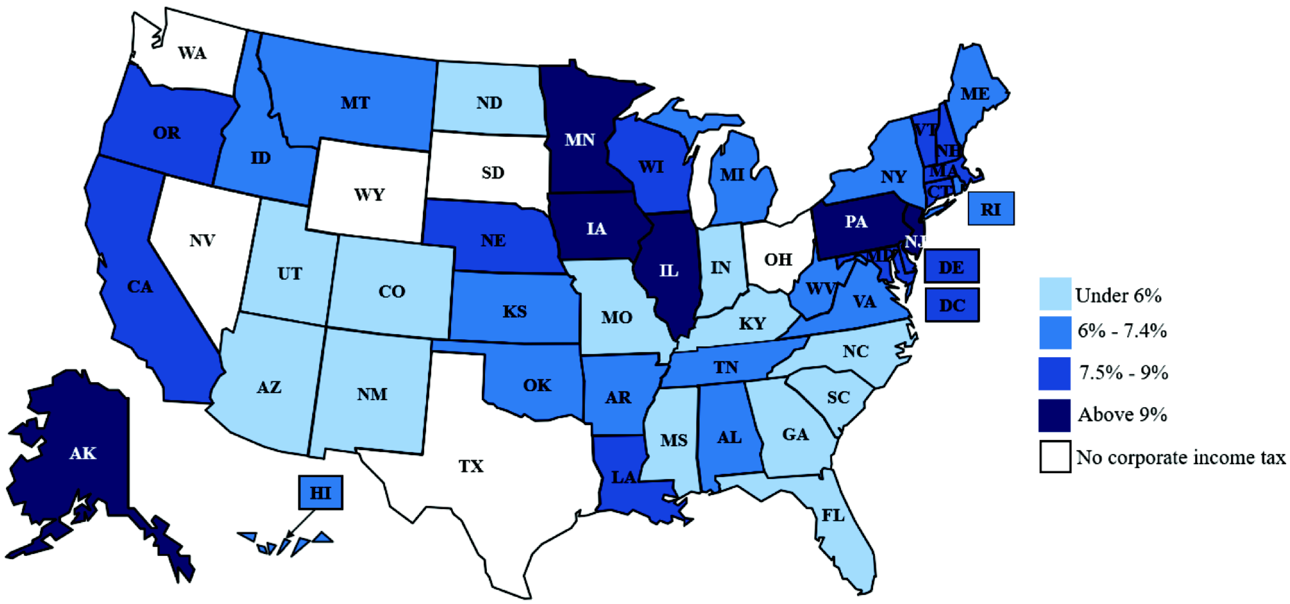
The Biden administration's proposal for corporate and personal income tax changes, introduced in April, calls for significant corporate tax rate increases on domestic income (from 21 percent to 28 percent) and on foreign income (from 10.5 percent to 21 percent) and for large increases in personal income tax rates for high-income households on capital gains and corporate dividends (from 23.8 percent to 43.4 percent).[93] The corporate tax rates on domestic- and foreign-source income are linked together as the Biden administration's rate for foreign-source income under the GILTI provisions is pegged at three-quarters of the rate on domestic-source income.

[91] P.L. 86-272 was formally named the Interstate Income Act of 1959. The Internet Tax Freedom Act was initially passed in 1998 (P.L. 105-277) and amended several times in subsequent years.

[92] *Quill*, 504 U.S. at 298.

[93] *See* Treasury, "The Made in America Tax Plan," *supra* note 86; White House, "Fact Sheet: The American Families Plan," *supra* note 87; Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," *supra* note 63. In comparing relative tax levels, the Biden administration highlights that the U.S. corporate income tax as a percent of GDP has declined from 2 percent before the TCJA to 1 percent after the TCJA and is lower than that in other OECD nations. There are several problems with this analysis. First, it does not reflect the significantly larger share of (flow-through) businesses taxed under the personal income tax in the United States than the OECD average (and thus not included as part of the CIT calculation). Second, it focuses on only the first-level tax on corporations (the corporate income tax), and not the second level of tax on corporate dividends (the personal income tax). Third, it reflects, in part, what is merely a timing difference as the TCJA's 100 percent expensing of capital investments temporarily lowered corporate income taxes. Fourth, U.S. taxes generally are one-third or more below OECD GDP averages because of the smaller-size U.S. government sector. Finally, there are also other measures of relative corporate tax levels that show the U.S. effective corporate tax rate is in line with other OECD nations. *See generally* Bunn and Garrett Watson, "U.S. Effective Corporate Tax Rate Is Right in Line With Its OECD Peers," Tax Foundation (Apr. 2, 2021); Watson and William McBride, "Biden Plan's Higher Taxation of Businesses Would Boost Collections to Highest in 40-Plus Years," Tax Foundation (July 8, 2021); Kyle Pomerleau and Donald Schneider, "The Biden Administration's Corporate Tax Statistic Is Misleading," *BNA*, Apr. 16,2021.

Figure 4.
State Corporate Income Tax Rates (2021)



The Aggregation of Federal and State Tax Levels

To make a fair global comparison of relative tax levels on corporate income and distributions, it is imperative that the proposed federal corporate and personal income tax rates are aggregated with existing state corporate and personal income taxes. The (unweighted) average state corporate tax rate for the 44 states (and the District of Columbia) with corporate income taxes is 6.9 percent.[94] Moreover, there is a wide spectrum of corporate income tax rates, with 28 states with rates under 7.5 percent, 12 states with rates of 7.5 percent to 9 percent, and six states with rates above 9 percent. (See Figure 4.) Taking state taxes into account, the aggregate federal/state corporate tax could be one-quarter or more higher in a state than the stand-alone federal tax.

The implications of aggregating federal and state corporate income tax rates are important in considering President Biden's proposal to increase the federal corporate income tax rate from 21 percent to 28 percent. On its own, the proposal would increase the U.S. rate to seventh among OECD countries. However, the blended federal/state tax rate would rise to 32.4 percent, the highest among OECD countries.[95] The blended federal/state rate would be higher in the 18 states with corporate income tax rates of 7.5 percent or more.

The absence of federal consideration of aggregate federal/state tax levels spills over into the public debate and media scrutiny as well. For instance, Sen. Joe Manchin III, D-W.Va., a key moderate Democrat, recently suggested that the U.S. rate should remain competitive and that he would not support anything above 25 percent.

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[94] Janelle Cammenga, "State Corporate Income Tax Rates and Brackets," Tax Foundation (Feb. 3, 2021). When the six states with no corporate income tax are included in the calculation, the average subnational corporate tax rate for all 50 states and the District of Columbia is about 6 percent. *Id.*

[95] Watson and McBride, "Evaluating Proposals to Increase the Corporate Tax Rate and Levy a Minimum Tax on Corporate Book Income," Tax Foundation, Fiscal Fact No. 751, at 2, 5 (Feb. 2021). The state corporate income tax rate included in the calculation is lower than the average state corporate income tax rate to take into account the federal deduction for state corporate income taxes paid, and the six states with no corporate income taxes. On the higher combined rates in states with over 7.5 percent corporate income tax rates, see Watson, "Combined Corporate Rates Would Exceed 30 Percent in Most States Under Biden's Tax Plan," Tax Foundation (Apr. 1, 2021). On the rates in other OECD countries, see Bunn et al., "President Biden's Infrastructure Plan Raises Taxes on U.S. Production," Tax Foundation, at 2 (Mar. 31, 2021).

Similarly, *The New York Times* editorial board in April expressed support for Biden's proposed corporate income tax rates of 28 percent on domestic income and 21 percent on foreign income. Neither Manchin nor the *Times* mentioned the impact of the additional corporate tax at the subnational level in the United States.[96]

The United States could end up exceeding global norms not only on the tax rates applied to U.S. businesses on their domestic-source income, but also on the tax rates applied to the U.S. affiliates of foreign MNCs doing business in the United States. The Biden administration has proposed replacing the BEAT provision with a new SHIELD provision that is similar to the pillar 2 UTPR in disallowing deductions for intragroup payments of foreign MNCs with operations in low-tax jurisdictions. However, unlike the UTPR, the SHIELD provision would not operate as a top-up tax for any income taxed in the low-tax jurisdiction at lower than the agreed minimum rate. Rather, the SHIELD provision would broadly deny deductions, with no cap on the tax effect of such denial, for payments made by a U.S. affiliate of a foreign-headquartered MNC with low-taxed income. Moreover, the impact of the SHIELD provision would be amplified by additional state corporate income taxes because states could link to this new provision through conformity to federal definitions of adjusted gross income.

Integrated Rates on Corporate Income and Distributions

The potential U.S. competitive disadvantage is more pronounced when the combined federal/state integrated rates on corporate income and corporate distributions are considered. In most, but not all, countries, corporate income is taxed twice — once when it is earned, and once when it is distributed to shareholders. The United States is currently at the lower end of the upper one-third of OECD countries in terms of the combined tax rate on corporate net income and corporate distributions to shareholders. If the Biden administration's proposed corporate and personal income tax rate increases are enacted, either fully or substantially, the blended U.S. federal/state tax rate on corporate income and distributions would jump to the highest among OECD countries.

Biden's plans call for a near doubling of personal income tax rates on corporate dividends and capital gains to 43.4 percent for households with over $1 million in income. When combined with the proposed corporate income tax rate increase to 28 percent and the average state tax rates on corporate income and distributions, the blended federal/state tax rate would total 65.1 percent — significantly higher than the highest integrated rate in any other OECD country.[97] Indeed, the U.S. combined blended rate would exceed the average OECD country integrated rate on corporate income and dividends by over half.[98]

Of course, in states with higher-than-average personal income tax rates on corporate distributions and capital gains, the tax would be higher. For instance, the average top marginal personal income tax rate typically applied to both corporate dividends and capital gains is 6.5 percent. There is, however, a wide range of top personal income tax rates among the states, with 13 states having rates of 7 percent or higher, including California at 13.3 percent (see Figure 5).[99]

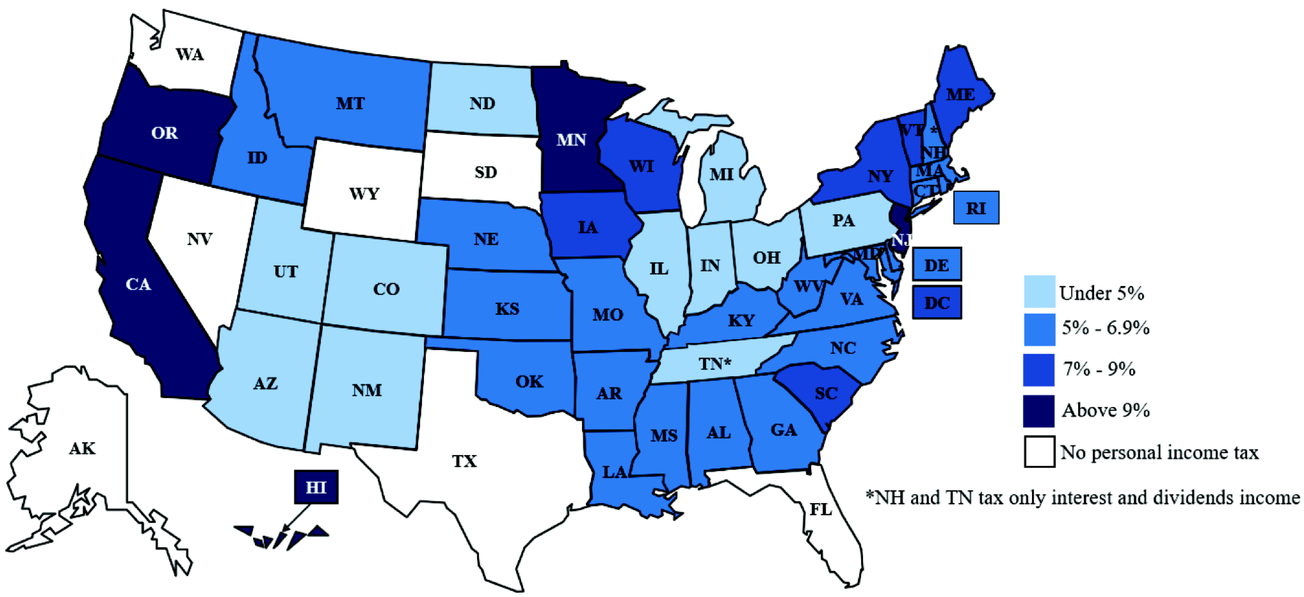
[96] On Manchin, see Erik Wasson and Steven T. Dennis, "Manchin Balks at Biden's Corporate Tax Increase, Favors 25 Percent Rate," *Bloomberg*, Apr. 5, 2021. On *The New York Times* editorial, see Opinion, "Make Tax-Dodging Companies Pay for Biden's Infrastructure Plan," *The New York Times*, Apr. 17, 2021. On a stand-alone basis, a new 25 percent federal rate would put the United States near the middle of the pack, tied with four other countries for 11th highest among OECD countries. However, the blended federal/state rate would be the sixth highest rate among the OECD countries. Bunn et al., "President Biden's Infrastructure Plan Raises Taxes on U.S. Production," *supra* note 95.

[97] Erica York, "U.S. Top Combined Integrated Tax Rate on Corporate Income Would Become Highest in the OECD," Tax Foundation (May 3, 2021). On rates in other OECD countries, see Taylor LaJoie and Elke Asen, "Double Taxation of Corporate Income in the United States and the OECD," Tax Foundation, Fiscal Fact No. 740, at 10 (Jan. 2021). The Tax Foundation international data comparisons included both central and subnational taxes. *Id.*, Figure 2.

[98] York, *supra* note 97; and LaJoie and Asen, *supra* note 97.

[99] Tax Policy Center, "State Individual Income Taxes, 2021" (Apr. 8, 2021).

Figure 5.
Highest State Personal Income Tax Rates (2021)



The rate disparity could also effectively constrain future state tax increases. If the proposed federal corporate and personal tax rate increases are enacted, in whole or in substantial part, they will likely have a "crowding out" impact on the states, either discouraging tax rate increases that may be under consideration at the state level or building pressure for state tax rate rollbacks. If states instead maintain or increase their tax rates, they will further aggravate any competitive disadvantage that exists for U.S. MNCs.

The Divergence in Global Minimum Tax Rate and Base on U.S. MNCs

The issue of tax parity between the United States and other advanced nations is of even greater consequence in connection with global minimum taxes on foreign income. In Part 1, we discussed the pillar 2 proposal for a system of global minimum tax rules. With these rules, each nation would have the ability to impose additional taxes on foreign income to which it has a connection to the extent such income is not taxed at the agreed minimum rate by the source country. The Biden administration has made similar, but more expansive proposals to increase the effective tax rate and broaden the tax base for U.S. MNCs on their foreign income under the GILTI provision and to impose additional tax on foreign MNCs based on their outbound payments under the new SHIELD provision.

In evaluating the potential for disparity between the U.S. and foreign country global minimum taxes, there are two flashpoints: tax rate parity and tax base parity. In terms of tax rate parity, the Biden administration has been vocal about its interest in a higher rate for the global minimum tax under pillar 2, urging use of a rate of at least 15 percent and stressing that the rate ultimately agreed to should be higher.

However, the Biden administration has given no indication that it will move away from its proposal for a 21 percent rate under the U.S. GILTI rules. While the political prospects of the administration's proposed tax plans are uncertain given the razor-thin majorities in the Senate and House and the scale and complexity of the combined budget and tax proposals, it has signaled that its focus is on eliminating low-tax-rate competition from other nations and not on potential risks associated with high-tax-rate disparity between the United States and other advanced nations.[100]

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[100] *See* "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," *supra* note 63, at 6.

Figure 6.
The Pillar 2 Income Inclusion Rule Compared With the Biden Administration's GILTI Proposal

	Timing of Tax	National Tax Rate	Additional Subnational Tax Rate*	Tax Base Determination	Calculation Method	Foreign Tax Offset	Mechanisms to Address Losses and Timing Differences
Pillar 2 Income Inclusion Rule	Current	Will be at least 15%	NA	Substance-based carveout for tangible assets and payroll	Country-by-country	Full offset for foreign taxes under top-up tax approach	Yes
Biden Administration Proposed Changes to GILTI Provision	Current	21% (75% of CIT rate of 28%)	4.2%	No substance-based carveout	Country-by-country	Credit for only 80% of foreign taxes	No

*Based on the average state tax rate, taking into account the federal deduction for state corporate taxes and reflecting a state inclusion of 75% of GILTI.

If the Biden administration corporate tax reform proposals are enacted, in whole or substantial part, the GILTI tax rate could end up in a range of between 18.75 and 21 percent, depending on the corporate income tax rate, with the potential for even higher tax if the haircut on FTCs is maintained and the rules on expenses are maintained or tightened. While the July 2021 agreement provides that the minimum tax rate under pillar 2 will be at least 15 percent, it is unlikely that the final agreed pillar 2 minimum tax rate will be as high as the currently proposed GILTI rate.

Similarly, in terms of the tax base, the Biden administration's GILTI proposal and the pillar 2 design are far apart. Both approaches would use a per-country calculation. However, the Biden administration is proposing to eliminate the QBAI deduction under the GILTI provision, while the pillar 2 design, in contrast, includes a substance-based carveout for income equal to at least a 7.5 percent rate of return on both payroll and tangible asset investments (which would decline to at least a 5 percent rate of return after a five-year transition period). (See Figure 6.) Moreover, the administration's GILTI proposal includes no mechanisms to address losses and timing differences. This further widens the tax base differential between the GILTI provision and the pillar 2 IIR, which includes such mechanisms.

The Aggregation of Federal and State Taxes on Foreign-Source Income

The foreign income tax rate and tax base disparity at the federal level between U.S. MNCs and their foreign counterparts is just the starting point for analyzing any competitive disadvantage for the United States. Even if the U.S. GILTI tax rate ends up closer to the agreed upon global minimum tax rate, the additional state taxation of foreign income could significantly skew the outcome. As discussed above, the average state corporate income tax rate is 6.9 percent, before taking into account a federal tax deduction for state corporate taxes paid.[101] If the Biden administration corporate tax proposals are enacted, in whole or substantial part, the aggregate federal/state GILTI tax rate could end up in a range of between 22.65 (18.75 percent + an

[101] Cammenga, *supra* note 94.

average state tax rate of 3.9 percent) and 24.7 percent (21 percent + an average state tax rate of 3.7 percent) in a state that taxes the portion of GILTI that is taxed at the federal level, depending on the federal corporate income tax rate.[102]

Second, the U.S. global minimum tax base disparity with other nations widens when aggregated with the state tax base inclusion of GILTI. The primary reason for this is the different methods used at the federal and state levels for taking into account foreign taxes paid on the GILTI amounts. At the federal level, any tax due on GILTI is reduced by at least a partial credit for foreign taxes. State corporate income tax laws, however, do not allow for FTCs. As a result, all GILTI, whether from low-tax or high-tax countries, is included in the state corporate income tax base, without any offset for foreign taxes paid.[103] For example, if three different U.S. MNCs generate $20 million of GILTI in three different countries, and one is subject to foreign tax at 0 percent, one at 10 percent, and one at 20 percent, it makes no difference for state tax purposes. The state tax base includes $20 million of GILTI in all three scenarios.

At the state level, formulary apportionment is typically used as a rough proxy for FTCs. For example, consider a typical state that uses a single-sales-factor apportionment formula. Assume that $50 million is earned in domestic income based on domestic sales of $400 million, 10 percent of which occur in the state; and $60 million is earned in foreign income based on foreign sales of $400 million, none of which occur in the state. The mechanics of the apportionment formula should yield $40 million of in-state sales in the numerator and $800 million of total domestic and foreign sales in the denominator, equaling an in-state apportionment ratio of 5 percent ($40 million/$800 million). The result is that 5 percent of the $110 million in combined domestic and foreign income, or $5.5 million in apportioned income, is subject to the corporate income tax in the state.

The problem, however, is that historically states have treated foreign-source income differently and allowed either no foreign factor representation (excluding the $400 million in foreign sales from the denominator of the sales factor) or included just the net foreign income (including $60 million in the denominator of the sales factor).[104] This results in an in-state apportionment ratio of 10 percent or 8.7 percent, in the above example, depending on whether no or limited foreign factor representation is allowed, applied to the combined domestic- and foreign-source income, resulting in doubling or close to doubling of the apportioned income subject to tax. This method is likely unconstitutional under the foreign commerce clause because it provides more favorable treatment for domestic commerce than for foreign commerce.[105] But until the issue is resolved in the courts, the inclusion of GILTI in the state tax base without either FTCs or full foreign factor representation will exacerbate the aggregate federal/state disadvantage relative to other countries.

About half of the states include GILTI or some type of foreign-source income in the state tax base. Since the TCJA was enacted in 2017, 20 of the 44 states (and the District of Colombia) with corporate income taxes have linked fully or partially to the federal GILTI provision. The taxable portion of GILTI varies from 5 percent to the federal amount of 50 percent. Several other states, including California and Minnesota, tax a portion of foreign dividends instead of adopting GILTI (see Figure 7).[106]

[102] The 3.9 percent and 3.7 percent state tax rates reflect: a federal corporate tax rate increase to 25 percent or 28 percent; a state tax base of 75 percent of GILTI, consistent with the proposed reduction in the federal section 250 deduction; and the average state tax rate after taking into account a federal tax deduction for state corporate income taxes.

[103] For the differences in the calculation of GILTI at the state and federal levels, see Joseph X. Donovan et al., "State Taxation of GILTI: Policy and Constitutional Ramifications," *State Tax Notes*, Oct. 22, 2018, p. 315. Of course, any state calculation must take into account the state-specific reduction of GILTI (analogous to the federal section 250 deduction), which could lower the amount of GILTI subject to state tax by 50 percent or more. The amount of GILTI in the state tax base could increase with a per-country calculation of GILTI because foreign losses in one country would not be offset against GILTI in another country.

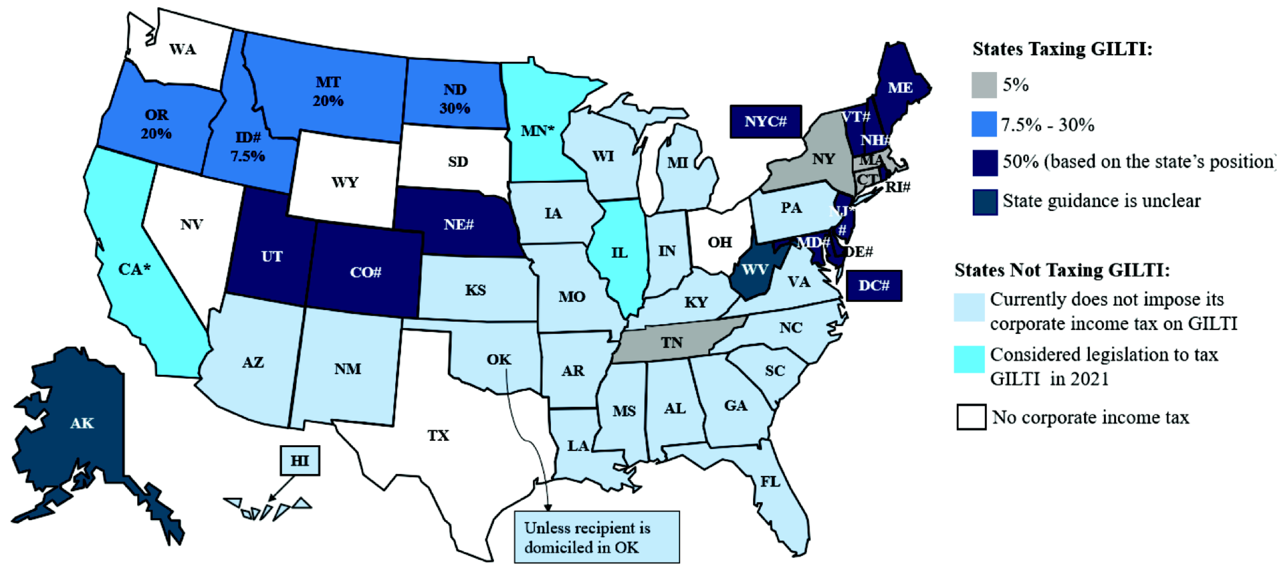
[104] *See* Frieden and Donovan, "Where in the World Is Factor Representation for Foreign-Source Income?" *State Tax Notes*, Dec. 23, 2019, p. 1077. Of the 20 states that tax some portion of GILTI, only one (Utah) provides for full foreign factor representation, allowing the inclusion of the foreign sales that resulted in the production of the GILTI amounts in the denominator of the sales factor. The other states either allow no foreign factor representation, provide no clear guidance, or, at best, permit the net GILTI amount (not the gross sales) to be included in the sales factor. *Id.* at Figure 4 (with updates by the authors).

[105] *Id.*

[106] Based on COST 2021 research.

Figure 7.
GILTI: State Corporate Income Tax Conformity

Generally based on 80% or more direct corporate ownership. Other rules may apply for smaller % ownership or personal income tax purposes.



 # CO, DC, DE, ID, KS, MD, NE, NJ, NH, NYC, RI, and VT allow section 250 deduction
*** CA, NJ, NH, MN, and VT tax a portion of foreign dividends when repatriated**

Disclaimer: This map is based on the best available information, but several states do not have clear guidance on GILTI. Therefore, this information should be used for general guidance and not relied upon for compliance.
Source: Council On State Taxation

State conformity to the GILTI provision, however, is not static. Some new states have conformed to the GILTI provision in the last two years while some other states have decoupled from it. More concerning from a global tax parity perspective is that several large states, including California, Minnesota, and Illinois, have seriously considered legislation to tax GILTI in 2021. California, the largest of all states from a population and GDP perspective, provides a cautionary tale of what state linkage to the GILTI provision might look like in the future. In late 2020 A.B. 71 was introduced in the California State Legislature. In 2021 A.B. 71 moved swiftly through the legislative process, passing through two Assembly subcommittees and the Assembly Appropriations Committee before it stalled for the year when considered by the entire Assembly.[107]

The proposed California legislation included several provisions that if enacted would significantly exacerbate the competitive disadvantage of U.S. MNCs by[108]:

- retroactively increasing California taxes on unrepatriated foreign income earned over a 30-year period (1986 to 2017) by 15 percentage points (from 25 percent to 40 percent of foreign dividends in the tax base) and providing no constitutionally required foreign factor representation;
- adding a new tax on 50 percent of GILTI and providing no foreign factor representation;
- basing these two new taxes on a questionable assertion that all such foreign income is "displaced domestic income"; and
- imposing these new taxes on top of a state income tax system with the highest combined tax rates on corporate income and

[107]Paul Jones, "California Bill to Tax GILTI Is Dead for 2021," *Tax Notes Today State*, June 7, 2021.

[108]On A.B. 71, see Frieden and Erica S. Kenney, "Eureka Not! California CIT Reform Is Ill-Conceived, Punitive, and Mistimed," *Tax Notes State*, May 24, 2021, p. 1057. Currently, for water's-edge filers, California taxes 25 percent of foreign dividends. *Id.*

corporate distributions of all but one other state.

Finally, the proposed California legislation failed to take account of the global minimum tax proposals at the federal and global levels. The proponents of the California legislation did not make allowances for the possible passage of federal legislation that could significantly change how the foreign income of U.S. MNCs is taxed.

The Competitive Disadvantage

Enactment of the Biden administration's proposals to increase the tax rate and tax base on GILTI could result in a significantly higher global minimum tax on U.S. MNCs than may be agreed to by the inclusive framework jurisdictions.[109] Even with passage of a scaled-down version of the administration's proposals, the combined federal/state GILTI tax rate and tax base could exceed the pillar 2 equivalents, especially if more states follow the global and U.S. approach and impose a minimum tax on foreign source income. Once again, this is a uniquely U.S. issue as the United States is the only country among the OECD or G-20 nations that has a state-level tax on active foreign-source income.

The potential for a competitive disadvantage for U.S. MNCs is not a new development. The United States for many years used a worldwide system of taxation that taxed U.S. MNCs at a higher corporate income tax rate (35 percent before the TCJA) on a broader global tax base (all foreign income subject to tax on a deferred basis when repatriated in the form of intercompany dividends) than the systems used by other advanced nations in taxing their own MNCs.

However, there is a difference between the previous U.S. tax regime and the new emerging global tax rules. In the past, the risk of a competitive disadvantage for U.S. MNCs could be partially or fully offset by two safety valves. First, foreign active business income was largely taxed on a deferred basis (when distributed as a dividend to the U.S. parent), not on a current basis (as in the case of the GILTI provision), and the tax could be delayed indefinitely if the income earned in foreign countries was not distributed back to the U.S. parent. Second, the variation in tax rates and systems among nations, without global minimum tax rules, provided U.S. MNCs with the opportunity to reduce taxes by locating in lower-tax jurisdictions.

The GILTI provision, especially if expanded by the Biden administration's proposed changes, largely eliminates both of these safety valves. A significant risk of the Biden corporate tax plan, if enacted, is that it will outpace any minimum tax rules implemented by other countries. If it does so, U.S. worries over low-tax-rate competition will give way to concerns about tax rate disparity. If the U.S. global minimum tax rate and base exceed the pillar 2 levels, the federal tax system and any conforming state systems could create a significant competitive disadvantage for U.S. MNCs relative to foreign MNCs.[110]

Given the importance of approaching the U.S. taxation of foreign income from an aggregate federal/state perspective, the federal government has at least two options to achieve some semblance of tax rate parity. First, it can use its powers under the U.S. Constitution's commerce clause to preempt the states from taxing any foreign income, and thus preserve its capacity to match or nearly match global minimum tax rates. Second, it can lower its own tax rate on GILTI to less than it would otherwise choose so as to not crowd out the states from taxing GILTI. Based on historical precedents, the federal government will likely follow neither path, leaving the United States vulnerable to a competitive disadvantage, even if the federal tax rate on GILTI (on a stand-alone basis) ends up close to the OECD's pillar 2 rate.

Alternatively, the states could recognize that if the federal tax rate on a U.S. MNC's foreign

[109] A recent study by the Penn Wharton Budget Model concluded that adopting the Biden administration's corporate tax proposals would result in an effective U.S. tax rate on foreign income that is more than twice as high as adopting the OECD proposal for a global minimum tax would make it. Penn Wharton Budget Model, Profit Shifting and the Global Minimum Tax (July 21, 2021).

[110] U.S.-based corporations make up 22 of the largest 50 MNCs in the world and 38 of the largest 100. Andrea Murphy et al., "Global 2000: The World's Largest Public Companies," *Forbes*, May 13, 2021. This is why many believe that low-tax-rate competition needs to be addressed at the national level, not the subnational level. Only at the national level can the government balance limiting competition from low-tax countries with avoiding a global minimum tax rate that disadvantages U.S. MNCs. Only at the national level can the government try to achieve parity with other countries' treatment of their own MNCs. Indeed, subnational income taxes are included in the ETR for purposes of determining the top-up tax under the OECD/G-20 pillar 2 proposal. *See supra* note 54.

income exceeds the agreed global minimum tax rate, then any additional state taxation of GILTI will exacerbate the competitive disadvantage for U.S. MNCs. The business community would likely advocate limits on or rollbacks of state taxation of foreign income if the federal tax system has already addressed potential profit shifting and low-tax-rate competition. In that case, all the key state arguments used in California (and in other states) to support the state taxation of GILTI — that foreign income is "displaced domestic income," that no foreign factor representation is required, and that corporations are not paying their fair share — will be swept away. Importantly, while the federal government can broadly impose corporate income taxes on a residence basis if it so chooses (on all income wherever earned), the Constitution limits states' power (outside the domiciliary state) to tax multistate businesses to a source basis (only on income earned from sources within that state).[111]

There are other limits on unilateral actions undertaken by the federal government or the states that create a competitive disadvantage for U.S. MNCs. This is particularly true if the rate or base disparity between U.S. and foreign MNCs grows to one-quarter or one-third or more, placing a significant premium on the country in which an MNC is headquartered. Among the possible outcomes, viewed by many as negative from a U.S. policy perspective, are inversions whereby a U.S. MNC becomes a foreign-parented company and thus escapes the U.S. GILTI regime; foreign buyouts, whereby foreign competitors are encouraged to purchase U.S. MNCs; or a slow and gradual decline in business investment and job creation as new businesses choose to incorporate, locate research and development, and make capital investments outside the United States.

Pillar 1 Risks for the United States

There are also some concerns about the potential for pillar 1 outcomes that could discriminate against U.S. MNCs. The primary risks in this regard are twofold: the scope of pillar 1 and the likelihood of its disproportionate application to U.S. MNCs; and any barriers to pillar 1 rules ultimately taking effect that could result in the retention and expansion of DSTs. Ironically, this second risk is reinforced by U.S. state-level DSTs that are proliferating based on a misguided copying of foreign DSTs.

As discussed in Part 1, at the Biden administration's urging, the scope of pillar 1 was narrowed in the July 2021 agreement of inclusive framework jurisdictions. The qualitative categories of automated digital services and consumer-facing businesses were replaced with the quantitative category of MNCs with more than €20 billion in turnover and more than 10 percent in profit. This change shifts the focus of pillar 1 away from digital businesses. However, even with the reduced scope, U.S. MNCs will likely shoulder a significant share of the tax increase expected under pillar 1.[112] Moreover, once the new rules are in place and familiarity with the economic nexus and formulaic market allocation concepts grows, the scope could be expanded to encompass a broader group of MNCs that continues to be disproportionately U.S.-based.[113]

The U.S. priority of ensuring that pillar 1 includes the repeal of DSTs was also reflected in the July 2021 agreement, which references coordination between the application of the new pillar 1 rules and the removal of all DSTs. The U.S. position on pillar 1 has always been centered on not allowing digital businesses to be singled out for disparate tax treatment. With U.S. MNCs as the world leaders in most digital business segments, the United States has taken a strong stand, under both the Trump and Biden

[111] Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* (2021 online version), Part IV, Ch. 6B, para. 6.04: "Consequently, when states seek to tax nonresident individuals and corporations, for which source is the sole jurisdictional basis, their power extends only to the nonresidents' property owned within the State and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources." *Id.*

[112] For estimates of the impact of pillar 1, see Devereux and Simmler, *supra* note 24.

[113] *See generally* Robert Goulder, "What Will Amount A Look Like in 10 Years?" *Tax Notes Int'l*, July 26, 2021, p. 535.

administrations, against the DSTs that have been enacted in the last three years.[114]

The United States Trade Representative (USTR) initiated a trade action against France, the first country to adopt a DST, almost immediately after its enactment. In the investigation phase, the USTR concluded that 90 percent of the burden of the French DST falls on U.S.-based MNCs[115] and that U.S. MNCs made up eight of nine digital advertising companies and 12 of 21 digital interface companies subject to the French DST.[116] The United States later launched similar trade actions against other countries, based on findings that DSTs discriminate against U.S. digital companies, are inconsistent with the principles of international taxation, and burden or restrict U.S. commerce.[117] The trade sanctions under these actions have been suspended while the work on pillar 1 continues. At the same time, DSTs can remain in place until agreed pillar 1 rules become applicable. Moreover, if implementation of the pillar 1 rules falters — a possible scenario given the complexity of the pillar 1 construct — there would be no requirement for removal of DSTs, and DSTs could continue to proliferate.[118]

The Illogic of State DSTs

The U.S. federal government's opposition to DSTs faces a challenge from a more unlikely source: subnational governments within the United States itself. Over the last two years, in reaction to the passage of DSTs in European and other nations, approximately 15 states have considered, and one state (Maryland) has enacted, new gross receipts taxes on digital advertising services or digital data collection (see Figure 8).[119] Indeed, it is likely that DSTs and other tax measures targeting digital businesses will populate the state tax landscape in the near future, regardless of initial legislative outcomes.

Many different and inconsistent justifications are provided for state adoption of DSTs. But there can be little doubt that the driving force behind the wave of state-level DST proposals is the precedential nature of and publicity afforded to the foreign DSTs.[120] Before these DSTs emerged, there was no discussion of DSTs at the state level in the United States. Since the EU considered, and France adopted, a DST, there have been numerous U.S. state proposals.

This direct connection between foreign DST enactments and state-level proposals makes it more surprising that the rationale for and temporary nature of the foreign country DSTs have been lost in translation. As illustrated in Part 1, state corporate income tax systems — virtually alone among national or subnational corporate income tax systems in the world — widely adopt economic nexus and market sourcing rules that facilitate the taxation of digital-only businesses and obviate the need for state DSTs. To date, the significant differences between the application of global and state-level tax rules to digital business models have not received much attention in the state-level debates on the need for or efficacy of DSTs.

Just as surprisingly, the strong opposition by both the Trump and Biden administrations to foreign DSTs has not been a factor in state-level considerations. The adoption of state-level DSTs undermines the United States' position opposing foreign DSTs and arguably "prevents the federal government from 'speaking with one voice when regulating commercial relations with foreign governments.'"[121]

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[114] *See generally* Congressional Research Service, "Section 301 Investigations: Foreign Digital Services Taxes (DSTs)" (updated Mar. 1, 2021).

[115] *See* Office of the USTR, "Notice of Action in the Section 301 Investigation of France's Digital Services Tax," *Federal Register*, July 16, 2020.

[116] Office of the USTR, "Section 301 Investigation: Report on France's Digital Services Tax," at 2 (Dec. 2, 2019).

[117] For a more detailed discussion of the opposition to unilateral DSTs, see generally Frieden and Do, *supra* note 28.

[118] In November 2020 U.S. Treasury released proposed regulations that would fundamentally change the determination of whether a foreign tax is creditable for U.S. tax purposes by incorporating a jurisdictional nexus requirement. REG-101657-20. The preamble to the proposed regulations states:

> In recent years, several foreign countries have adopted or are considering adopting a variety of novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction as reflected in the Internal Revenue Code. . . . In light of these developments, the Treasury Department and the IRS have determined that it is appropriate to revisit the regulatory definition of a foreign income tax to ensure that to be creditable, foreign taxes in fact have a predominant character of "an income tax in the U.S. sense."

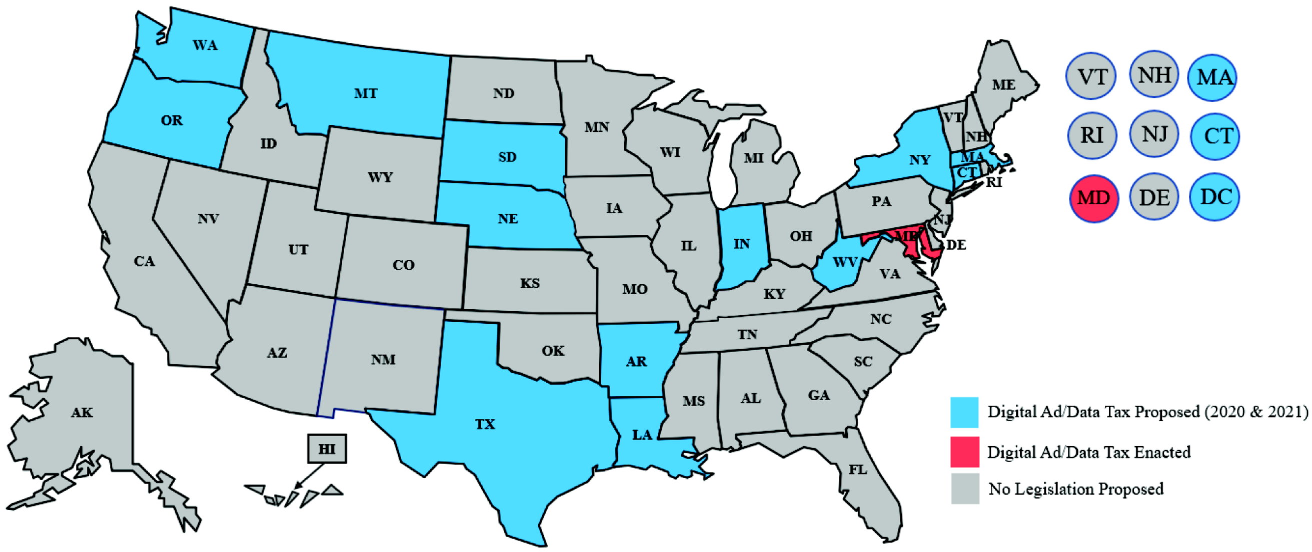
The preamble further references DSTs as among these "novel extraterritorial taxes" and notes that no inference is intended regarding their treatment under the existing FTC regulations.

[119] Based on 2021 COST research. The effective date of the Maryland DST has been delayed until tax years beginning after December 31, 2021. Maryland S.B. 787.

[120] Frieden and Do, *supra* note 28, at 592-594.

[121] *Japan Line Ltd. v. Los Angeles County*, 441 U.S. 434, 444-445 (1979) (establishing the two-part test for determining when a state tax violates the foreign commerce clause).

Figure 8.
2020 & 2021 Digital Advertising Services & Data Tax Proposals



Disclaimer: This information should be used for general guidance and not relied upon for compliance.
Source: Council On State Taxation

As with the matter of parity between U.S. and global tax rates on foreign income, the disconnect between federal and state government approaches to digital commerce, if left unaddressed, could significantly undermine U.S. tax policy goals regarding the digital economy. State governments are out of step with the functionality of their own income tax statutes, the direction of other nations, and the vehement opposition of the U.S. federal government to foreign DSTs.

The U.S. Disproportionate Reliance on Income Taxes

The United States faces not only short-term risks from a potential divergence with the new global income tax architecture fostered by the OECD/G-20 BEPS 2.0 changes, but long-term systemic risks as well because of the design and composition of the U.S. federal/state tax system. The United States is the only advanced nation in the world that has no broad-based consumption tax at the central or federal government level.[122] This unique feature of the U.S. tax system limits the federal government's options when addressing new federal budgetary needs or rising federal debt to increasing income and social insurance taxes, potentially exacerbating income tax disparity with other countries.

The United States' disproportionate reliance on income taxes and underreliance on consumption taxes relative to international norms is readily apparent in global tax data. The United States is less reliant on consumption taxes as a share of overall taxes than any other advanced nation in the world.[123] In 2019 consumption taxes accounted for about 17.6 percent of all taxes in the United States, compared with 32.3 percent of all taxes in OECD nations (see Figure 9).[124] In China, consumption taxes account for about 41.3 percent of all taxes.[125]

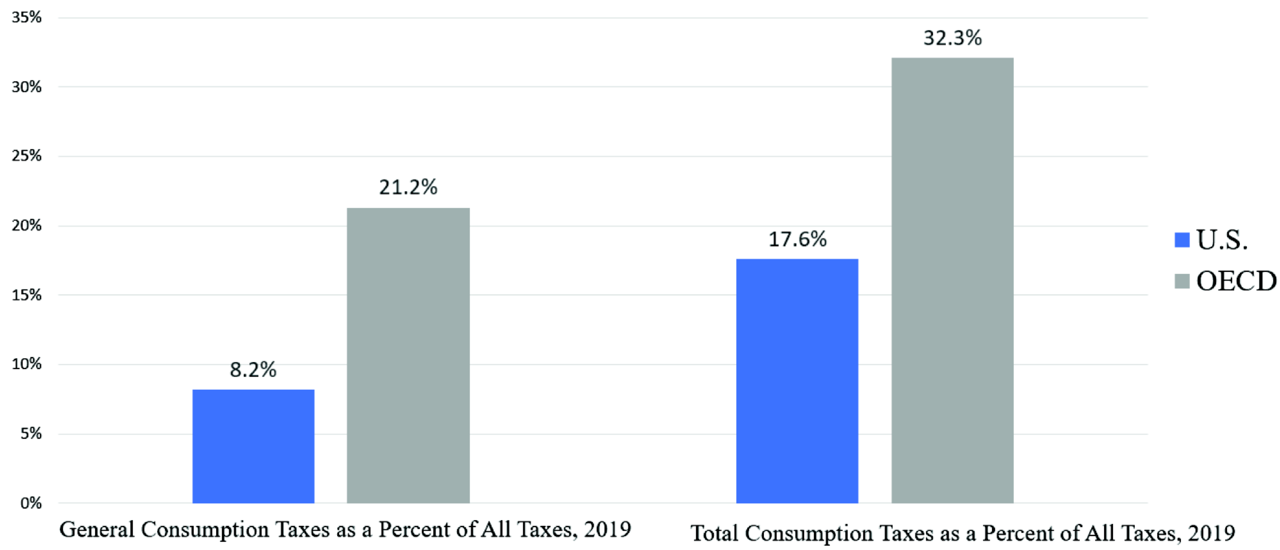
[122]EY, *supra* note 77.

[123]The United States relies less on consumption taxes as a share of total tax revenues than any of the over 100 nations included in the OECD global data for 2019. *See* OECD, Global Revenue Statistics Database, chart of taxes on goods and services as a percent of all taxes for 2019.

[124]OECD, "Revenue Statistics — OECD Countries: Comparative Tables," tbl. 5000, as measured by share of total taxation. The OECD nations' averages are unweighted. The U.S. data is included in the OECD data because the United States is an OECD member, but because the data is unweighted, the U.S. share of 1/37 of the OECD calculation does not materially change the average.

[125]OECD, *supra* note 78.

Figure 9.
The U.S. Relies Less on Consumption Taxes Than All Other Advanced Nations (as a Share of All Taxes)



Roughly one-third of consumption taxes in OECD nations consist of excise taxes on specific goods and services such as gasoline, cigarettes, liquor, and customs and import duties. The other two-thirds are derived from general consumption taxes on goods and services. The United States' relative underreliance on general consumption taxes as a share of all taxes (about two-fifths of the OECD average) is even greater than its underreliance on all consumption taxes (about one-half of the OECD average). In 2019 taxes on general consumption accounted for 8.2 percent of all taxes in the United States, compared with 21.2 percent of all taxes in OECD nations. (See Figure 9.)[126]

Moreover, the gap between the United States and other advanced nations has widened over the last 40 years. Taxes on general consumption as a share of total taxation in the United States increased modestly from 7 percent in 1975 to 8.2 percent in 2019, or about one-fifth. By comparison, taxes on general consumption as a share of total taxation in the OECD nations increased significantly from 13.4 percent in 1975 to 21.2 percent in 2019, or about three-fifths.[127]

Conversely, even before taking into account the Biden administration's proposed net corporate and personal income tax increases, the United States relies more on revenues from the other three major tax types — income, social insurance (payroll), and property — than any other advanced nation.[128] In 2019 taxes on income, social insurance, and property accounted for over four-fifths of all taxes in the United States, compared with about two-thirds in OECD countries.[129]

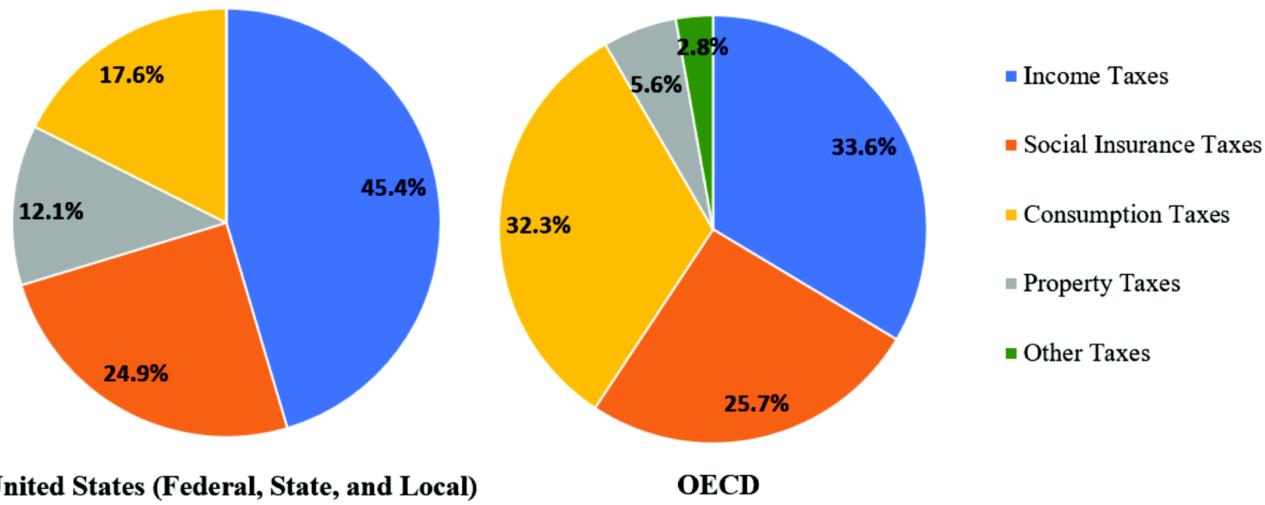
[126]OECD, *supra* note 124, tbl. 5110, as measured by share of total taxation.

[127]*Id.* at tbl. 5110, as measured by share of total taxation. Similarly, taxes on general consumption as a share of GDP in the United States increased from 1.7 percent in 1975 to 2 percent in 2018, or by about one-fifth. By contrast, taxes on general consumption as a percentage of GDP in the OECD nations increased from 4.2 percent in 1975 to 7.3 percent in 2018, or by about three-quarters. *Id.* at tbl. 5110, as a share of GDP.

[128]OECD, *supra* note 78.

[129]OECD, *supra* note 124, tbl. 1000 (income and profit taxes), tbl. 2000 and 3000 (social insurance taxes), tbl. 4000 (property taxes), tbl. 5000 (consumption taxes), tbl. 6000 (other taxes).

Figure 10.
The U.S. Relies More on Income, Social Insurance, and Property Taxes Than Any Other Advanced Nation: Average Sources of Tax Revenue (2019)



The differential is most pronounced with income taxes. Corporate and personal income taxes account for 45.4 percent of all taxes in the United States, compared with the average of 33.6 percent in the OECD nations (see Figure 10).[130]

The Imbalance of Revenue Sources Is More Pronounced at the Federal Level

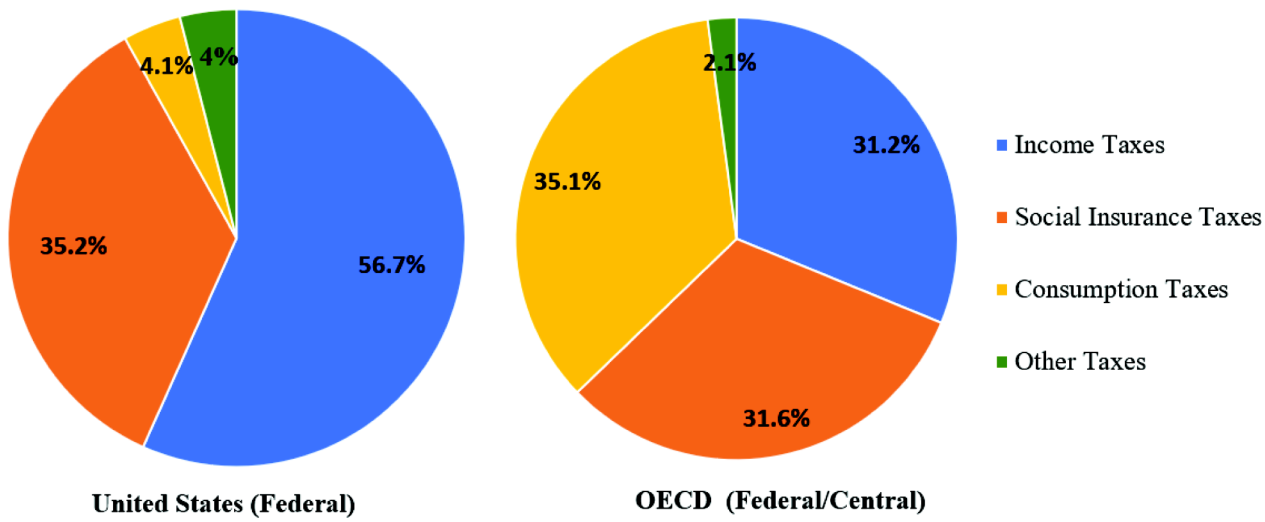
The imbalance of revenue sources is even more pronounced at the federal level. Without a general consumption tax at the national level, the United States relies on a two-legged stool (income and social insurance taxes) for revenue, rather than the three-legged stool (income, social insurance, and consumption taxes) used by other advanced nations. Income and social insurance taxes make up 92 percent of all federal government revenues, compared with an average of 62.8 percent among all OECD nations. Income taxes (both corporate and personal) alone make up 56.7 percent of the U.S. federal government revenues — almost twice as much as the average of 31.2 percent for all OECD federal/central governments (see Figure 11).[131]

Conversely, general consumption taxes make up 0 percent of all U.S. federal taxes, compared with an average of 23.4 percent at the federal/central government level in the OECD nations. The United States does impose consumption taxes on specific goods and services (for example, motor fuels, alcohol, tobacco, airplane tickets, import duties) at the federal level. But total

[130] *Id.* Corporate and personal income taxes are combined in this (and other) statistical analyses because over half of all business income (i.e., from S corporations, limited liability companies, partnerships, and sole proprietors) in the United States is taxed under the personal income tax. On the growth of the share of passthrough entities as a share of all business income, see generally Jason DeBacker and Richard Prisinzano, "The Rise of Partnerships," *Tax Notes*, June 29, 2015, p. 1563; Michael Cooper et al., "Business in the United States: Who Owns It and How Much Tax Do They Pay?" U.S. Treasury Office of Tax Analysis Working Paper 104 (Oct. 2015); and Conor Clarke and Wojciech Kopczuk, "Business Income and Business Taxation in the United States Since the 1950s," National Bureau of Economic Research Working Paper 22778 (Oct. 2016). On the disproportionate share of tax revenue collected from passthrough entities in the United States, see Bunn and Watson, *supra* note 93; and Watson and McBride, *supra* note 93.

[131] Data is for 2018. The OECD data is from: OECD, Revenue Statistics, *supra* note 124, tbls. 2000 (social security statistics); and 1000, 3000, 4000, 5000, and 6000 (federal or central government level statistics). The OECD separates social security taxes from the federal/central government totals, so the two are combined for purposes of this comparison. On share of central government in OECD total taxes, see OECD, Revenue Statistics 2020: Tax Revenue Trends in the OECD, Table 3, at 13. The U.S. data is from: Congressional Budget Office, "The Budget and Economic Outlook: 2019-2029," 91 tbl. 4-1 (Jan. 2019). About three-quarters of the OECD nations do not have a system of "federalism," so the national governments in these countries are referred to as "central" governments.

Figure 11.
The U.S. Two-Legged Stool vs. the OECD Three-Legged Stool:
Sources of Taxes at the Federal/Central Government Level



consumption taxes make up only 4.1 percent of all federal taxes, compared with an average of 35.1 percent of all taxes at the federal/central government level in the OECD nations (see Figure 11).[132]

The Rise in Federal Debt Will Exacerbate Existing Income Tax Disparities

The absence of a general consumption tax option at the federal level in the United States is particularly significant because that is where virtually all the long-term public debt is accumulating and where a disproportionate share of future tax increases will likely occur. Unless the composition of taxes at the federal level is changed, any future federal tax increases will fall heavily or exclusively on income and social insurance taxes, exacerbating any income tax rate disparity between the United States and other advanced nations.

Federal debt in the United States is rising to levels never before reached in peacetime, in large measure because of stimulus and relief spending to counter the last two recessions and the COVID-19 pandemic. For instance, pandemic-related stimulus and relief spending of $5.5 trillion in 2020 and 2021 resulted in the two highest years of federal deficits since World War II.[133] Based on Congressional Budget Office statistics, the federal debt-to-GDP ratio will rise to about 103 percent in 2021, compared with 79 percent at the end of 2019 and 35 percent in 2007, before the start of the previous recession.[134] This level of federal debt is nearly triple the 40-year average of federal debt before 2007, and close to the World War II record level of 106 percent.[135]

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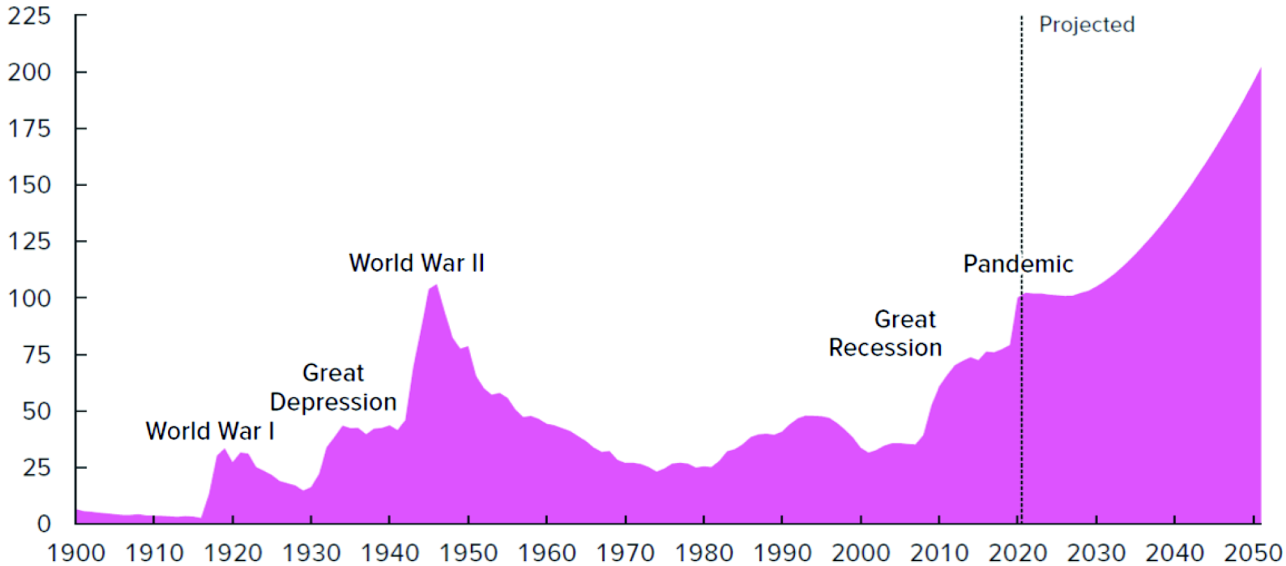
[132] *Id.*

[133] CRFB, "New Budget Projections Show Record Deficits and Debt" (Mar. 11, 2021).

[134] CBO, "An Update to the Budget and Economic Outlook: 2021 to 2031" (July 2021). CBO, "The 2021 Long-Term Budget Outlook" (Mar. 2021). CRFB, "Analysis of CBO's March 2021 Long-Term Budget Outlook" (Mar. 4, 2021). These estimates do not include any additional debt incurred as a result of the enactment of the Biden administration's proposed budget. *See* CRFB, "President Biden's Full FY2022 Budget" (May 28, 2021).

[135] *See* CBO, *supra* note 134; and CRFB, *supra* note 134.

Figure 12.
Federal Debt Held by the Public, 1900 to 2051
Percentage of Gross Domestic Product



Source: Congressional Budget office. See www.cbo.gov/publication/56977#data.

Furthermore, unfunded liabilities for healthcare and Social Security for an aging U.S. population and other provisions in current laws are projected to nearly double the debt-to-GDP ratio to 202 percent by 2051 (see Figure 12).[136] Over the last 50 years, the average gap (deficit) between federal government spending and revenues was about 3.3 percent of GDP. However, based on current law projections, the CBO estimates an upward trajectory of the average federal deficit to 5.5 percent of GDP in 2031, 9.4 percent of GDP in 2041, and 13.3 percent of GDP in 2051.[137]

The Fiscal Crossroads

The United States is approaching a fiscal crossroads. As pressure builds to balance government spending with government revenues, the federal government's two-legged stool of income and social insurance taxes may prove inadequate to the task. The enactment of the Biden administration tax proposals, in whole or substantial part, could stretch the U.S. income tax system to its limits in terms of disproportionate reliance on income taxes.[138]

With little room to maneuver, addressing long-term fiscal needs at the federal level with even more reliance on income or social insurance taxes would be risky, further moving the United States away from global norms. Either the United States will run into political limitations on

[136] CBO, *supra* note 134. The CRFB estimates that under an alternative (and more pessimistic) scenario the debt-to-GDP ratio could reach 259 percent in 2051. CRFB, *supra* note 134. Alan Auerbach et al., "Fiscal Effects of COVID-19," Brookings Papers on Economic Activity (Sept. 24, 2020).

[137] CRFB, *supra* note 134; and CBO, *supra* note 134. The CBO predicts that federal government spending (including interest payments) will total 31.8 percent of GDP by 2051 while federal revenue will total only 18.5 percent of GDP. Many other nations also have growing levels of national debt as a share of GDP. But the United States is unique among advanced countries in its need to address the debt problem with a federal tax system disproportionately reliant on income and social insurance taxes.

[138] Under the Biden administration's tax proposals, aggregate business income tax collections under the corporate income tax and personal income tax (flow-through entities) would increase to 3 percent of GDP in 2022, and average 3.2 percent of GDP from 2022 to 2031 — a level that has only been reached one other time in the last four decades. This calculation does not include the additional proposed changes to capital gains and other personal income tax rates. *See* Watson and McBride, *supra* note 93.

revenue-raising from such a limited base or it will exacerbate global competitive disadvantages by increasing income tax rate disparities with other advanced nations.[139]

Even if it is possible to raise additional federal taxes solely from income and social insurance taxes, the underreliance on consumption taxes relative to global norms is of concern because non-income taxes are viewed by many as providing the government with one of the most effective means of raising revenue without deterring economic growth. Economists have long favored consumption-based tax systems over income-based tax systems for their capacity to mitigate adverse impacts on domestic investment and job creation and minimize tax penalties on exports.[140]

The OECD, although focused on global income tax reform, has emphasized the importance of an appropriate balance of non-income taxes in the overall composition of taxes. In 2018 the OECD published a report that highlighted the need to:

> shift the tax mix away from income taxes toward taxes that have less negative impacts on economic growth, including taxes on property and on consumption . . . A tax mix shift towards taxes on less mobile tax bases can ensure that the tax system becomes more resilient and is less vulnerable to the effects of globalization.[141]

Conclusion

The convergence of international and U.S. federal and state corporate income taxes portends a new era in global taxation. The pillar 1 and 2 proposals, reflecting both U.S. state and federal tax concepts, could fundamentally change the global tax architecture, partially replacing physical presence rules with economic nexus principles and the arm's-length principle with formulaic market allocations, as well as establishing global minimum tax rules.

There are potential benefits for U.S. tax policy from these changes, including introducing the concepts of economic nexus and formulaic market allocations without discarding traditional principles; eliminating DSTs that discriminate against U.S. MNCs; and gaining broad international support for global minimum tax rules that limit low-tax-rate competition and could create the basis for a more level playing field between nations.

However, potential short-term risks to the United States exist, primarily from unilateral actions either by foreign countries or the United States itself. The pillar 1 proposals could still falter, which would leave DSTs that target U.S. MNCs in place. The pillar 2 global minimum tax rules could be overtaken if the United States puts in place rules imposing relatively higher tax levels that handicap U.S. businesses in international trade and hurt the United States as a competitive location for foreign investment.

Longer-term risks exist as well, because the design and composition of the unique U.S. federal/state tax system are ill-equipped to adapt to global competition and long-term fiscal demands. Convergence in global income tax rates and levels is inherently unstable for the United States if it remains an outlier with its near total dependence on income and social insurance taxes at the federal level.

The global BEPS 2.0 project is gaining momentum, but it is still uncertain how broadly the pillar 1 and 2 rules will be adopted, and what the final tax design will be. Similarly, the outcome of the Biden administration's U.S. tax proposals is unknown as they make their way through the political process and the U.S. Congress.

The possibility remains that the United States will stay within the mainstream of converging global tax policy, thus avoiding divergence in a way that creates competitive disadvantages for U.S. MNCs and the U.S. economy. But to do so, the United States must carefully calibrate its response to the global tax initiative and approach federal tax policy from the perspective of the aggregate impact of its federal and state tax system.

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[139] See Brookings Institution economist William G. Gale's estimates of the budget cuts and tax increases required to reduce the federal debt by two-thirds in 2050. Gale, "Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future" *Oxford Univ. Press* (2019).

[140] *See* Frieden and Lindholm, *supra* note 82, at 897-898. For a detailed analysis of the historical development of consumption taxes at the subnational (and not the national) level in the United States, the shortcomings of U.S. state sales tax systems, and possible solutions for transforming federal and state consumption taxes, see Frieden and Lindholm, "A Global Perspective on U.S. State Sales Tax Systems as a Revenue Source: Inefficient, Ineffective, and Obsolete," State Tax Research Institute (forthcoming Sept. 2021).

[141] OECD, "Tax Policies for Inclusive Growth in a Changing World," at 15 (July 2018).

In the short term, this means avoiding the imposition of higher federal/state income tax levels on U.S. MNCs than other countries levy on their own MNCs. In the long term, this means addressing the imbalance in tax composition, particularly at the federal government level, that makes it very likely that any disparity in income tax levels will increase over time. ■