JULIA SKUBIS WEBER and **MATT JENNER** are Partners, and **EMILY BERG** is an Associate in Baker McKenzie's Chicago office. **ETHAN KROLL** is a Partner in Baker McKenzie's Los Angeles office. **STEWART LIPELES** is a Partner in Baker McKenzie's Palo Alto office.

International Tax Watch

Three Taxes, Two Pillars, One Credit?

By Julia Skubis Weber, Matt Jenner, Emily Berg, Ethan Kroll, and Stewart Lipeles

In recent years, many countries responded to concerns that the current international tax system does not adequately capture the digitalization of the global economy by taking matters into their own hands. Despite ongoing negotiations to reach a global "two-pillar" solution, nearly half of the member countries of the Organisation for Economic Co-operation and Development ("OECD"), including the UK, France, Italy, and Spain, and dozens of non-OECD countries, have announced, proposed, or implemented digital service taxes ("DSTs") and other similar measures (collectively, "Unilateral Measures").[1] These Unilateral Measures generally tax the gross revenues of large digital companies, many of which are domiciled in the United States. In response to the perceived discrimination, the United States launched investigations and threatened significant tariffs in retaliation.

DSTs have passed another milestone with two recent announcements. On October 8, 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting ("IF") announced that 136 jurisdictions had reached a landmark deal.[2] These countries, including the United States, joined the *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (the "Two-Pillar Statement"), in which they agreed to a two-pillar solution to address the tax challenges arising from the digitalization of the economy.[3] Out of the 141 members of the OECD/G20 Inclusive Framework on BEPS, only Kenya, Nigeria, Pakistan, and Sri Lanka have not yet joined the agreement.

The Two-Pillar Statement reported that some member countries were discussing transitional arrangements with respect to Unilateral Measures "expeditiously." Less than two weeks later, on October 21, 2021, the UK, Austria, France, Italy, Spain, and the United States announced in a joint statement that they had reached a compromise regarding a transitional approach to existing Unilateral Measures until Pillar 1 comes into effect (the "Joint Statement").[4]

This column discusses the proposed phase-out of DSTs as provided in the Joint Statement, particularly in light of the recent progress on Pillar 1 and the proposed U.S. Treasury ("Treasury") regulations, published in late 2020, providing the jurisdictional nexus requirement for the availability of a foreign tax credit.

The OECD's Two-Pillar Solution

The Two-Pillar Statement confirms that Pillar 1 will tax two amounts, Amount A and Amount B, but the Two-Pillar Statement only provides final agreement with respect to Amount A.[5] Multinational enterprises ("MNEs") with gross revenue above EUR 20 billion and before-tax profits in excess of 10% of revenue, determined by reference to financial accounting income, will have 25% of residual profit (Amount A) allocated to market jurisdictions with sufficient "nexus." Here, a "special purpose" rule applies to establish nexus if an MNE derives at least EUR 1 million of revenue from that jurisdiction.[6]

Pillar 1 thus purports to ensure a "fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable multinational enterprises" by "re-alloca[ting] some taxing rights over MNEs from their home countries to the markets where they have business activities and earn profits, regardless of whether firms have a physical presence there."[7] Amount A is allocated among jurisdictions using a revenue-based allocation key. The tax base for Amount A will be determined by allowing loss carryforwards, and if a market jurisdiction already taxes an MNE's residual profits, a to-be-determined safe harbor will cap the residual profits allocated to the market jurisdiction through Amount A. The Two-Pillar Statement provides that MNEs will be able to avail themselves of an exemption or a credit to address the risk of the profit allocated to market jurisdictions being subject to double taxation. The Two-Pillar Statement also provides that the implementing agreement will contain dispute resolution mechanisms.

A multilateral convention will implement Amount A, with the reallocation of income starting in 2023. In conjunction with the implementation, the multilateral convention will require all parties to remove existing DSTs and "other relevant similar measures," as well as commit to not introduce new measures going forward.

DSTs and Creditability

DSTs generally are imposed on the gross revenue arising from the provision of digital services to a customer, such as digital advertising, intermediation platforms, or the sale of user data. As measures that seek to better tax the global revenues from the digital economy, DSTs raise a host of questions with respect to their treatment for U.S. foreign tax credit purposes. Even before Treasury and the IRS released proposed foreign tax credit regulations in September 2020, DSTs presented some complex issues in the creditability analysis. This column does not seek to analyze the creditability of DSTs under the current regulations. Rather, we focus on additional limitations in the 2020 proposed regulations (the "Proposed Regulations") that, if finalized, likely would render most DSTs uncreditable.

To mitigate double taxation of foreign source income, Code Sec. 901 allows a dollar-for-dollar credit for income, war profits, and excess profits taxes paid to a foreign country. Treasury Regulations set forth the conditions for determining when a foreign levy is a foreign income, war profits, or excess profits tax (collectively, an "income tax") that is creditable under Code Sec. 901. Under Reg. §1.901-2, each foreign levy is evaluated on a separate basis and is an income tax "if and only if—(i) It is a tax; and (ii) The predominant character of that tax is that of an income tax in the U.S. sense."[8] To account for withholding taxes that most countries impose as a substitute for an income tax, Code Sec. 903 then provides that, for the purposes of the foreign tax credit rules, an income tax includes taxes paid *in lieu* of an income tax otherwise imposed by a foreign country.

In the Proposed Regulations, Treasury and IRS sought to "require that a foreign tax conform to traditional international norms of tax jurisdiction as reflected in the Internal Revenue Code to qualify as an income tax in the U.S. sense or as a tax *in lieu* of an income tax."[9] Treasury and the IRS viewed the proposed rules as necessary and appropriate to ensure foreign tax credits operate as intended to mitigate double taxation of income that is attributable to foreign activities or investment. We highlight several of the more notable proposed changes below—tightening the net gain requirement, revising the substitution requirement under the "*in lieu* of" test, and adding a jurisdictional nexus requirement.

The Net Gain Requirement

Under Reg. §1.901-2(a)(3), the predominant character of a foreign tax is that of an income tax if the foreign tax is likely to reach net gain in the normal circumstances in which it applies (the "net gain requirement") and it is not a "soak-up" tax. The Proposed Regulations revise the net gain requirement to better align the regulatory tests for realization, gross receipts, and net income (or cost recovery) (in Reg. §1.901-2(b)(2), (3), and (4), respectively) with the definition of an income tax in the United States.

The existing foreign tax credit regulations provide that a foreign tax must reach net gain in the "normal circumstances" in which it applies. The Proposed Regulations tighten the net gain requirement by narrowing the situations in which an empirical analysis is relevant to determining the nature of the foreign tax, thus minimizing the relevance of the "normal circumstances" in which the tax applies. Treasury and the IRS believe this will yield more accurate, consistent, and administrable outcomes. With respect to the cost recovery element of the net gain requirement, in particular, the Proposed Regulations remove the rule that allowed a tax on gross income to satisfy the requirement provided taxpayers subject to the tax are almost certain never to incur a loss (after payment of the tax). In addition, the recovery of significant costs and expenses allowed under the foreign tax law would need to approximate the cost recovery provisions under the Code.[10]

Generally, many taxpayers have looked to Reg. §1.901-2(b)(4)(i)(B) for comfort that even a foreign tax that is nominally imposed on gross revenues without recovery of all significant costs and expenses may, so long as its computational methodology is "likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses," satisfy the net income requirement. The current regulations only require that the foreign taxable base, when "judged on the basis of its predominant character," is computed by reducing gross receipts by significant costs and expenses (or an approximation thereof).[11] In contrast, the Proposed Regulations would provide that all significant costs and expenses (determined empirically with respect to all taxpayers in the aggregate) must be recovered, and that certain costs (capital expenditures, interest, rents, royalties, services, or research and experimentation) are always treated as significant costs or expenses for this purpose. Any denial of recovery of these significant costs must conform to the way the Code denies those costs. Overall, the revised net gain requirement under the Proposed Regulations would make it materially more difficult for gross-basis DSTs to qualify as income taxes.

The Substitution Requirement

Even if a foreign tax is not a tax on net income, it may be creditable under Code Sec. 903 as a tax *in lieu* of an income tax. In considering whether a foreign tax (a "tested foreign tax") is *in lieu* of an income tax, under the current Code Sec. 903 regulations, it is immaterial what a country's purpose is in imposing the tested foreign tax and whether the base of the foreign tax bears any relation to realized net income. The foreign tax must operate as a tax imposed in substitution for, not in addition to, an income tax (the "substitution requirement").[12] Additionally, a foreign tax satisfies the substitution requirement to the extent that liability for the foreign tax does not depend upon the availability of an income tax credit for the foreign tax in another country.[13] The examples under the current regulations clarify that if the tax at issue applies in conjunction with an income tax, without a reduction or exemption for those subject to the tax in question, then the tax does not meet the substitution requirement.[14]

The Proposed Regulations would set forth four prongs that a taxpayer must satisfy for the tested foreign tax to qualify as an "*in lieu* of" tax.[15] First, a separate levy that is a net income tax must be "generally imposed by" the same foreign country (the "generally-imposed net income tax").[16] Second, neither this generally-imposed net income tax nor any other foreign income tax imposed by the same foreign country can be imposed on income that relates to amounts that form the base of the tested foreign tax ("excluded income").[17]

The third prong is satisfied if the generally-imposed net income tax would be imposed on the excluded income, but for the existence of the tested foreign income tax.[18] To satisfy this requirement, the tested foreign tax must bear a "close connection" to the failure to impose the generally-imposed net income tax on the excluded income. A taxpayer can demonstrate proof of this close connection if: (i) there is an express exclusion of the excluded income; or (ii) it can establish that the foreign country made a "cognizant and deliberate choice" to impose the tested foreign tax instead of the generally-imposed net income tax. The proof must be based on foreign tax law or the legislative history of either the tested foreign tax or the generally-imposed net income tax.

Fourth, it must be that, if the generally-imposed net income tax were applied to the excluded income, the generally-imposed net income tax, itself, would qualify as a foreign income tax or as a separate levy that is a foreign income tax.[19] This fourth test ensures that any "*in lieu* of" taxes on excluded income would have been subject to a tax that satisfies the jurisdictional nexus requirement, discussed below.

The additional requirements to satisfy the substitution requirement would add significant hurdles to demonstrating creditability under Code Sec. 903. The examples in the current regulations suggest that exclusion from income tax is sufficient to meet the substitution requirement. The current regulations do not require a taxpayer to show that it otherwise would be subject to a generally-imposed net income tax, and in particular taxpayers need not demonstrate a but-for relationship between the income tax and the "*in lieu* of" tax.[20] In Example 3, a gross income tax on nonresidents applies to payments for technical services performed by nonresidents outside of country X and meets the substitution requirement in Code Sec. 903. Although country X generally imposes a tax on realized net income, nonresidents are not subject to that tax. Example 3 has provided a helpful touchstone for some taxpayers evaluating whether a DST imposed on the gross income of nonresidents could be considered an "*in lieu* of" tax under Code Sec. 903.[21] If the Proposed Regulations are finalized, the requirement to demonstrate that a nonresident is otherwise subject to an income tax generally imposed by the jurisdiction in question may be fatal to creditability. Further, a company could be subject to both the generally-imposed net income tax and their country's DSTs, in which case there is no substitution. The fourth prong—the requirement that the income tax that the tested foreign tax is substituting satisfies the jurisdictional nexus requirement—presents another major obstacle for both income and "*in lieu* of" taxes.

Jurisdictional Nexus

The biggest hurdle to creditability of DSTs—and, indeed, to creditability of the taxation of Amount A under Pillar 1—would be finalization of the Proposed Regulations' jurisdictional nexus requirement. The current regulations do not contain any jurisdictional limitations on the definition of an income tax. The Proposed Regulations introduce a jurisdictional nexus rule that could affect DSTs and the taxes imposed under Pillar 1. The preamble to the Proposed Regulations states that the fundamental purpose of foreign tax credits "is served most appropriately if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax."[22] This conformity extends beyond comparing the tax bases in United States and foreign country, "but also to whether there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax."[23] Treasury and the IRS recognized that foreign jurisdictions have been adopting or considering "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."[24]

To ensure that foreign taxes have a predominant character of an income in the U.S. sense, Treasury and the IRS proposed the nexus rule in Proposed Reg. §1.901-2(c)(1) and (2).[25] In Proposed Reg. §1.901-2(c)(1), the nexus rule looks to traditional notions of nexus to determine whether the amount of income subject to tax is based on the nonresident's activities in the foreign country, such as whether the income relates to operations, employees, factors of production, or management in that foreign country. Rules similar to those set forth in Code Sec. 864(c) or Articles 5 and 7 of the U.S. Model Income Tax Convention for taxing profits attributable to a permanent establishment satisfy the nexus rule. In contrast, location of the customers, users, or any other similar destination-based criterion to allocate profit will not. Any source of income rules that apply must be similar to those that apply for U.S. federal income tax purposes. Specifically, the preamble states that income from services must be based on the place of performance of the service, not the location of the services recipient. A similar nexus rule applies under Proposed Reg. §1.901-2(c)(2) to foreign taxes imposed on the worldwide income of residents of that foreign country. Any allocations to or from the resident made pursuant to the foreign country's transfer pricing rules must be determined under arm's-length principles, without factoring in the location of the customers, users, or any other similar destination-based criterion.

The IRS has acknowledged that the nexus rule as proposed is far reaching. Neither DSTs nor the taxation of Amount A under Pillar 1 would impose tax on the basis of in-country activities carried on by the taxpayer, and these taxes would be expected to fail the jurisdictional nexus requirement. Commentators have argued that nexus rule was a particular response to DSTs and the OECD's continued developments, but the IRS has contested that notion, asserting that the nexus rule was drafted with more than DSTs in mind.[26] In addition, Treasury and the IRS acknowledge in the preamble to the Proposed Regulations that the United States' approach to crediting foreign taxes—including the jurisdictional nexus standard, if finalized—may need to be revisited depending on the outcome of the OECD Inclusive Framework negotiations:

> As part of its response to the extraterritorial tax measures referred to in this Part VI.A.2 of the Explanation of Provisions, the Treasury Department has been actively engaged in negotiations with other countries, as part of the OECD/G20 Inclusive Framework on BEPS, to explore the possibility of a new international framework for allocating taxing rights. If an agreement is reached that includes the United States, the Treasury Department recognizes that changes to the foreign tax credit system may be required at that time.[27]

The Joint Statement

In the Joint Statement, the United States, together with five countries with DSTs in place, agreed on a plan to withdraw DSTs in light of the impending implementation of Pillar 1. The UK, Austria, France, Italy and Spain preferred for the withdrawal of their Unilateral Measures to be contingent on Pillar 1's implementation, whereas the United States preferred for the withdrawal to take effect immediately as of October 8. The Joint Statement reaches a compromise, allowing the UK, Austria, France, Italy, and Spain to maintain their existing Unilateral Measures (*i.e.*, their DSTs) until Pillar 1 takes effect in exchange for providing a credit for a portion of DSTs paid during that period. The Joint Statement refers to the period beginning January 1, 2022, and ending on the earlier of the date the Pillar 1 multilateral convention comes into force or December 31, 2023, as the "Interim Period."

To facilitate this compromise, the UK, Austria, France, Italy, and Spain agreed to provide a credit for the excess of the taxes accrued under their existing Unilateral Measures during the Interim Period, regardless of whether the taxes were actually paid, over the amount equivalent to the tax due under Pillar 1 in its first full year of implementation, adjusted to achieve proportionality with the length of the transitional time (the "Interim Pillar 1 Amount"). The credit is applied against the portion of the corporate income tax liability reallocated to each of the respective countries under Pillar 1. If an MNE is not subject to Amount A when it first takes effect (*i.e.*, an MNE that does not meet the gross revenue threshold), the credit will be determined based on the first year in which Amount A applies to the MNE. The credit will be available to the MNE at the time Amount A begins to apply, unless the MNE does not become subject to Amount A more than four years after Amount A comes into effect in the country providing the credit. If the credit exceeds the liability arising under Amount A in a taxable year, the excess shall be carried forward and reduced in each subsequent taxable year until the credit has been fully used.

In exchange, the United States agreed to terminate any proposed trade actions and commit not to impose any trade actions against the UK, Austria, France, Italy, and Spain with respect to their existing DSTs until the earlier of when Pillar 1 comes into force or December 31, 2023. The countries party to the Joint Statement further agreed to regular discussions regarding the implementation progress of Pillar 1. By remaining in contact, the parties seek to ensure a continued common understanding of the respective commitments and any implications the implementation may have on the agreement. The parties agreed to resolve any differences through constructive dialogue.

The Joint Statement contains an example of the compromise framework. In the example, XYZ is a corporate taxpayer that is part of an MNE group that is subject to Pillar 1 tax liability in its calendar taxable year ("TY") 2024. Country A is one of the UK, Austria, France, Italy and Spain. The Interim Period begins on January 1, 2022, and the interim period for Country A ends on December 31, 2023.

During the Interim Period, XYZ pays EUR 100x in taxes to Country A with respect to its DST. On January 1, 2024, Country A implements Pillar 1 (effective for the 2024 calendar year and all subsequent years) and repeals its DST. XYZ's corporate income tax liability with respect to Pillar 1 is EUR 20x in calendar TY 2024 and EUR 25x in TY 2025. XYZ's Interim Pillar 1 Amount is EUR 40x, calculated by multiplying the EUR 20x Pillar 1 tax liability in TY 2024 by the number of days in the Interim Period (*i.e.*, 730) divided by 365. XYZ's total corporate income tax liability (including but not limited to Pillar 1 liability) with respect to TYs 2024 and 2025, before application of the credit, is EUR 110x and EUR 70x, respectively.

The Joint Statement example concludes with the following results. XYZ receives a credit from Country A of EUR 60x (the "Credit Amount"), calculated as its EUR 100x DST liability less the EUR 40x Interim Pillar 1 Amount. Because XYZ's corporate income tax liability with respect to Pillar 1 in TY 2024 is less than the Credit Amount, the EUR 20x corporate income tax liability is reduced to EUR 0x. The remaining EUR 40x credit is carried forward and reduces XYZ's corporate income tax liability of EUR 25x in TY 2025 to EUR 0x. The remaining EUR 15x credit is carried forward to TY 2026. Accordingly, XYZ's total corporate income tax liability for TY 2024 after applying the credit is EUR 90x (*i.e.*, EUR 110x liability minus the EUR 20x credit). XYZ's total corporate income tax liability for 2025 after applying the credit is EUR 45x (*i.e.*, EUR 70x liability minus EUR 25x carryforward credit).

Creditability of DSTs During the Interim Period

The United States agreed to both the Two-Pillar Statement and the Joint Statement. These agreements did not address whether a U.S. company that was subject to Pillar 1 Amount A or a DST would be entitled to a foreign tax credit in the United States. As discussed above, DSTs in isolation may struggle to meet the requirements of a creditable tax under current Code Secs. 901 and 903, particularly the substitution requirement. In the event that Treasury and the IRS finalize the Proposed Regulations, it will be even harder for DSTs to satisfy these requirements. Treasury officials have stated publicly that they expect to finalize the Proposed Regulations, somewhat close to their proposed form, by the end of 2021.[28] Given the statements in the preamble to the Proposed Regulations that "changes to the foreign tax credit system may be required" in the event that the OECD reaches an agreement that includes the United States, it seems reasonably likely that the taxes imposed under Pillar 1 ultimately would meet U.S. creditability requirements as reconfigured to suit the new international tax world order.[29] In that case, for the Interim Period, one could consider whether these DSTs are operating *in lieu* of the taxes under Pillar 1 Amount A.

As part of the Joint Statement, the UK, Austria, France, Italy, and Spain agreed to withdraw all Unilateral Measures when Pillar 1 takes effect, but they remain during the Interim Period. One year after Pillar 1 takes effect, companies will receive a credit that serves to "convert" DST tax liability paid in excess of the Pillar 1 Amount A into a prepayment of Amount A. For those companies subject to Pillar 1 Amount A, in effect, the credit will cap the amount of the past DST liability at the amount of tax each company would have paid had Pillar 1 taken effect on January 1, 2022, based on their revenues in the first year of Pillar 1 (*i.e.*, not the years in which DSTs were paid). Importantly, many companies subject to DSTs will not have Amount A liability, and thus no use for the credit. These companies doubtless would have preferred a deal that provided a refund of the "excess" DST.

In the Joint Statement example, XYZ paid a total EUR 100x in TY 2022 and TY 2023 under Country A's DST. Are any of these foreign taxes creditable for U.S. tax purposes? Different creditability questions arise for DSTs paid up to the Pillar 1 amount and DSTs paid in excess, although the local taxing statute is the same for both amounts. In the example, these amounts are the EUR 40x Interim Pillar 1 Amount and the EUR 60x Credit Amount.

The EUR 40x Interim Pillar 1 Amount represents the amount XYZ would have paid had Pillar 1 taken effect on January 1, 2022 (based on XYZ's 2024 revenue), and had Country A withdrawn its DST in accordance with the Joint Statement compromise. XYZ does not receive a credit from Country A for this amount because the EUR 40x tax liability is a proxy for XYZ's Pillar 1 tax liability during the Interim Period. The EUR 60x Credit Amount paid in TY 2022 and TY 2023 is above and beyond the hypothetical Pillar 1 tax liability for those years. Under the Joint Statement, XYZ receives a credit from Country A for this amount to reduce its actual Pillar 1 liability. Whereas the EUR 40x is a proxy for the Pillar 1 Amount A liability, the EUR 60x is paid as an advance against the unknown Pillar 1 liability in a subsequent year, if the taxpayer turns out to have a Pillar 1 Amount A liability in that subsequent year.

For both scenarios (*i.e.*, the EUR 40x Interim Pillar 1 Amount and the EUR 60x Credit Amount), the tested foreign tax is the Country A DST. The first prong of the substitution requirement in the Proposed Regulations requires there to be an income tax generally imposed by the same foreign country. Here, that tax would be the Country A Pillar 1 tax. We assume for purposes of this exercise that, as suggested in the Preamble, Treasury and the IRS would have revised the requirements for an income tax, such that the Country A Pillar 1 tax would satisfy the requirements of a net income tax and would be considered generally imposed. We nevertheless recognize that even this standard may prove challenging to meet—especially if Treasury relents only on the jurisdictional nexus requirement in the Proposed Regulations, and leaves untouched the stricter standards for cost recovery (for example). It is also questionable whether taxes under Pillar 1 could be considered "generally imposed" for this purpose. As currently contemplated, Amount A allocation under Pillar 1 would only reach certain businesses that meet a high global revenue threshold. Perhaps most significantly, the regulations require that the tax "*is*" generally imposed. Interestingly, the Country A Pillar 1 tax should be an extension of Country A's corporate income tax, which is generally imposed, but it is likely that the Country A Pillar 1 tax would be viewed as a separate levy. During the Interim Period, Pillar 1 taxes technically are not yet being imposed on anyone. In any event, taxpayers can reasonably argue that the Two-Pillar Statement created the Pillar 1 tax regime. Moreover, taxpayers can reasonably take the position that the Joint Statement essentially converts Interim Period DST payments into prepayments of Pillar 1 taxes.

The second prong is met as long as the foreign country does not impose any other income tax on income that relates to amounts that form the base of the tested foreign tax. This prong should be satisfied as long as Country A does not impose additional tax on income taxed under the Country A DST. Taxpayers generally should be able to satisfy this test because, as a general matter, countries implemented DSTs to increase their tax bases. While certain domestic taxpayers are in scope of their countries' DSTs, the DSTs generally tax income that otherwise would not have been subject to tax in their respective jurisdictions.

The third prong requires that the generally-imposed net income tax would be imposed on the income subject to the tested foreign income tax, but for the existence of the tested foreign income tax. Here, this requirement appears to be met. Based on the language of the Joint Statement, Country A arguably has made a "cognizant and deliberate choice" to impose the Country A DST instead of the Pillar 1 tax. The Joint Statement makes clear that the EUR 40x Interim Pillar 1 Amount is a proxy for the Pillar 1 amount that would be imposed. In addition, for the EUR 60x Credit Amount, arguably there is an express exclusion of the underlying income because the taxpayer can credit this amount against its future Pillar 1 tax liability.

The fourth prong under the substitution test applies the jurisdictional nexus requirement to an "*in lieu* of tax" because the generally-imposed net income tax, if applied to the excluded income (*i.e.*, the income subject to the tested foreign tax), must satisfy the jurisdictional nexus requirement. If jurisdictional nexus remains a requirement for the substituted-for income tax, the foreign tax on Pillar 1 Amount A should fail this test. Alternatively, if Treasury revises or removes the jurisdictional nexus requirement to permit creditability of Pillar 1 taxes, as we believe it should, and the Pillar 1 tax applied to the income that was subject to the EUR 40x Interim Pillar 1 Amount, this tax presumably would generally satisfy the jurisdictional nexus requirement. Because the EUR 40x amount is a proxy based on income in TY 2024, it is possible that a portion of the Interim Pillar 1 Amount would not satisfy this requirement, which could possibly put the creditability of the entire amount in jeopardy. For the EUR 60x Credit Amount, the argument may be even more difficult because this represents an amount above and beyond the expected Pillar 1 tax liability for the Interim Period.[30] Therefore, the Credit Amount is less likely to satisfy the jurisdictional nexus requirement during the Interim Period.

In summary, the main barriers to creditability for taxpayers appear to be the first and fourth prongs of the Proposed Regulations' substitution requirement. The first prong may not be met because the Pillar 1 tax is not generally imposed during the Interim Period. Taxpayers should be able to point to the Two-Pillar Statement as evidence that the Pillar 1 Amount A tax should be considered generally imposed, in particular if the Amount A tax is considered an extension of the jurisdiction's regular corporate income tax. In addition, the fourth prong may not be met to the extent that DSTs paid exceeds the amount that would have been due under Pillar 1 in the taxable year. Although we have discussed the Interim Pillar 1 Amount and the Credit Amount separately above, it is possible that the IRS would view those amounts as the same levy and deny a credit for the entire amount.

These issues create uncertainty for taxpayers that are subject to DSTs and other Unilateral Measures during the Interim Period. In addition, if the Credit Amount of any DST is not creditable when paid, there could be future foreign tax credit issues for taxpayers. Assuming Pillar 1 taxes are (eventually) creditable under Code Sec. 901, if XYZ does not receive foreign tax credits for this EUR 60x when paid, XYZ will lose EUR 60x of foreign tax credits when its otherwise creditable Pillar 1 tax liability is reduced in TYs 2024, 2025, and 2026.[31] The result is a trade of creditable taxes for non-creditable taxes. Treasury and the IRS could possibly take the position that agreeing to the Joint Statement was not a concession that DSTs should give rise to U.S. foreign tax credits. That approach would be inconsistent with United States' decision to cooperate with other members of the OECD IF and endorse the foreign tax on Pillar 1 Amount A. If the foreign tax on Pillar 1 Amount A is, in the United States' view, appropriate, then it is appropriate for the United States to provide a means for U.S. taxpayers to obtain a credit for DSTs in the United States so that the income is not subject to double tax.

Even with progress made in the Two-Pillar Statement and the Joint Statement, many questions remain unanswered. For example, if an MNE is not subject to Pillar 1 within four years (*e.g.*, if the company does not meet the gross revenue threshold), do the credits expire or would these countries allow the credits to offset another tax? The Unilateral Measures will be withdrawn when Pillar 1 takes effect, but will these other companies be subject to a different tax on the revenue that had been subject to the Unilateral Measures until Pillar 1 takes effect? If so, what do these taxes look like?

Additionally, this column has focused on the U.S. foreign tax credit provisions under the Code, but bilateral and multilateral treaties provide another possible route to creditability. Indeed, the point of bilateral income tax treaties is preventing double taxation. Unfortunately, the legacy structure of these agreements focuses on taxation of business profits and withholding taxes on payments, rather than taxes on gross revenues. Many DSTs arguably were designed to resemble turnover-type taxes on gross revenue so that they would be outside the scope of our income tax treaties.[32] As mentioned above, Pillar 1 will require a multilateral convention for implementation. In addition to joining the multilateral convention, the United States also would need to revamp its bilateral treaty network for purposes of its own domestic implementation of the two-pillar agreement. These newly negotiated agreements may provide treaty overrides with respect to domestic laws and regulations that deny foreign tax credits on, for example, jurisdictional nexus grounds. Whether this massive undertaking is feasible *via* the traditional ratification process, as a legislative or political matter, remains to be seen.[33] Nonetheless, treaties are an essential companion to domestic legal and regulatory changes required for accommodating taxation of the digital economy.

With respect to the jurisdictional nexus requirement, the Proposed Regulations also were promulgated one year before the OECD IF negotiations led to a fruitful agreement. Thus, while DSTs are some of the "novel extraterritorial taxes" that the Proposed Regulations sought to target, the landscape has changed. As discussed above, the preamble to the Proposed Regulations acknowledged this possibility, noting that changes to the foreign tax credit system may be required if the OECD IF reached an agreement that includes the United States. The digital economy is here to stay. While a long-term solution is coming together, Pillar 1 will not come into effect until 2024, and the mechanics of the short-term compromises remain a maze for taxpayers to navigate.

ENDNOTES

1 Eike Asen, *What European OECD Countries Are Doing About Digital Services Taxes*, TAX FOUNDATION, Mar. 25, 2021, available online at *taxfoundation.org/digital-tax-europe-2020/*.

2 Mauritania joined the IF and became the 137th country to join the Two-Pillar Statement on November 4, 2021. *Mauritania Joins the Inclusive Framework on BEPS and Participates in the Agreement to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD, Nov. 4, 2021, available online at *www.oecd.org/tax/beps/mauritania-joins-the-inclusive-framework-on-beps-and-participates-in-the-agreement-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm*.

3 *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD, Oct. 8, 2021, available online at *www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf*.

4 *Joint Statement from the United States, Austria, France, Italy, Spain, and the United Kingdom, Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 is in Effect*, U.S. Dep't Treasury, Oct. 21, 2021, available online at *home.treasury.gov/news/press-releases/jy0419*. In November 2021, Treasury announced that the United States had reached similar agreements with Turkey and India. *Joint Statement from the United States and Turkey Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 Is in Effect*, U.S. Dep't Treasury, Nov. 22, 2021, available online at *home.treasury.gov/news/press-releases/jy0500*; *Treasury Announces Agreement on the Transition from Existing Indian Equalization Levy to New Multilateral Solution Agreed by the OECD-G20 Inclusive Framework*, U.S. Dep't Treasury, Nov. 24, 2021, available online at *home.treasury.gov/news/press-releases/jy0504*.

5 Amount B intends to simplify the arm's-length principle with respect to baseline marketing and distribution activities, and work to develop this standard is expected to be completed by the end of 2022. Pillar 2 introduces a global minimum corporate tax rate of 15% for MNEs with revenue above EUR 750 million through a series of coordinating rules.

6 A reduced nexus threshold applies at EUR 250,000 of income for jurisdictions with GDP lower than EUR 40 billion.

7 *International Community Strikes a Ground-Breaking Tax Deal for the Digital Age*, OECD, Oct. 8, 2021, available online at *www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm*.

8 Reg. §1.901-2(a)(1). As of the time of this writing, the Proposed Regulations have not been finalized.

9 Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income, REG-101657-20, 85 FR 72078, 72087 (2020).

10 Proposed Reg. §1.901-2(b)(4).

11 *See, e.g.*, Reg. §1.901-2(b)(4)(iv), Example 1 (foreign bank tax "neither provides for recovery of significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery," but could qualify as an *in lieu* of tax if the foreign tax on corporations (excluding banks) is generally imposed).

12 *See* Reg. §1.903-1(b)(1).

13 Reg. §1.903-1(b)(2).

14 *See, e.g.*, Reg. §1.903-1(b)(3), Example 5 (excise tax payable independently of the income tax regime would not be creditable); Rev. Rul. 91-45, 1991-2 CB 336 (an assets tax of 2% could be imposed in addition to an income tax, and therefore could not qualify as an *in lieu* of tax for purposes of Code Sec. 903).

15 A tested foreign tax can also satisfy the substitution requirement if it is a "covered withholding tax." *See* Proposed Reg. §1.903-1(c)(2). Covered withholding taxes are outside the scope of this article.

16 Proposed Reg. §1.903-1(c)(1)(i).

17 Proposed Reg. §1.903-1(c)(1)(ii).

18 Proposed Reg. §1.903-1(c)(1)(iii).

19 Proposed Reg. §1.903-1(c)(1)(iv).

20 Reg. §1.903-1(b)(3), Examples 1–4.

21 There are, however, companies that are subject to both a jurisdiction's corporate income tax and its DST. Since there is nothing in principle that says a DST taxpayer cannot also be subject to the regularly imposed income tax in the country, the substitution requirement remains the main barrier to creditability under the current regulations.

22 REG-101657-20, 85 FR 72078, 72088.

23 *Id.*

24 *Id.*

25 A prior column contains a more detailed discussion of the jurisdictional nexus rule in the Proposed Regulations. *See* Joshua D. Odintz, Stewart Lipeles, and Julia Skubis Weber, *Location, Location, Location and Foreign Tax Credits*, 99 TAXES 7 (May 2021).

26 Andrew Velarde and Annagabriella Colon, *FTC Nexus Rule Is About More Than Digital Services Tax*, TAX NOTES (Nov. 6, 2020).

27 REG-101657-20, 85 FR 72078, 72089.

28 *See* Andrew Velarde, *Treasury on Track for Release of FTC Final Regs This Year*, 104 TAX NOTES INT'L 821 (Nov. 15, 2021).

29 *See, e.g.*, Craig Hillier and Colleen O'Neill, *Jurisdictional Nexus and Evolving International Norms*, 50 TAX MGMT. INT'L J. No. 11 (Nov. 3, 2021). ("At a time of so much global uncertainty, finalizing the jurisdictional nexus rules in the Proposed Regulations does not seem sensible, especially given Treasury's acknowledgement that many of these rules will need to be changed to accommodate foreign domestic tax laws adopted under Pillar One and Two.")

30 For many DST taxpayers, the expected Pillar 1 Amount A tax will be zero as they will not be in scope. This would seem to put both the EUR 40× Interim Pillar 1 Amount and the EUR 60× Credit Amount on the same footing for purposes of Code Secs. 901 and 903.

31 The multiple levies rule would treat the amount of Pillar 1 tax paid by XYZ in TY 2024 and TY 2025 as EUR 0 for foreign tax credit purposes (and would reduce the Pillar 1 tax paid in TY 2026 by EUR 15×). *See* Reg. §1.901-2(e)(4); Proposed Reg. §1.901-2(e)(4).

32 *See, e.g.*, *Digital Services Tax: Consultation*, Her Majesty's Treasury (2018), available online at *assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754975/Digital_Services_Tax_-_Consultation_Document_FINAL_PDF.pdf* (stating that the UK DST is a tax on gross receipts, applied "separately to, and not in place of, corporate tax," and is therefore not a listed tax for purposes of the OECD Model Tax Convention).

33 *See* Mindy Herzfeld, *Can the United States Make Good on Its International Tax Commitments?* 173 TAX NOTES FEDERAL 904 (Nov. 15, 2021).