EDITORIAL

The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties*

1 Introduction: Top-up Tax and the Four Interlocking Pillar Two Rules

On 20 December 2021 the OECD published detailed rules aimed at ensuring that multinational enterprises (MNEs) will be subject to a minimum 15% effective tax rate beginning in 2023. According to the OECD:

> [t]he rules define the scope and set out the mechanism for the so-called Global Anti-Base Erosion (GloBE) rules under Pillar Two, which will introduce a global minimum corporate tax rate set at 15%. The minimum tax will apply to MNEs with revenue above EUR 750 million and is estimated to generate around USD 150 billion in additional global tax revenues annually.[1]

These rules are to be introduced in national legislation, and it is uncertain whether they will be compatible with bilateral tax treaties concluded by the states that will adopt the new regime.[2] In order to understand their compatibility with bilateral tax treaties, the GloBE rules must be characterized.

According to the OECD:

> [t]he rules create a "top-up tax" to be applied on profits in any jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum 15% rate.

The new Pillar Two model rules will assist countries to bring the GloBE rules into domestic legislation in 2022. They provide for a coordinated system of interlocking rules that:

– define the MNEs within the scope of the minimum tax;
– set out a mechanism for calculating an MNE's effective tax rate on a jurisdictional basis, and for determining the amount of top-up tax payable under the rules; and
– impose the top-up tax on a member of the MNE group in accordance with an agreed rule order.[3]

In its recent commentary to the GloBE Model Rules, the OECD refers to the top-up taxes 'rather than a typical direct tax on income' as an 'international alternative minimum tax' and 'a coordinated tax charge'. Moreover, '[t]he design of the IIR and UTPR as Top-up Taxes, … does not restrict a jurisdiction from legislating those rules under a corporate income tax system in its domestic law'.[4]

Notes

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[1] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*: Inclusive Framework on BEPS 7 (OECD, Paris 2021), https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-theeconomy-global-anti-baseerosion-model-rules-pillar-two.htm (accessed 19 Mar. 2022).

[2] 137 Members of the OECD/G20 Inclusive Framework on BEPS joined the Oct. 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy as of 4 Nov. 2021: OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy – 8 Oct. 2021*, https://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; and, https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf.

[3] OECD releases Pillar Two model rules for domestic implementation of 15% global minimum tax, 21 Dec. 2021, https://www.oecd.org/tax/beps/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm (accessed 19 Mar. 2022).

[4] '2. The GloBE Rules apply a system of Top-up Taxes – that is, an IIR and a UTPR – that brings the total amount of taxes paid on an MNE's Excess Profit in a jurisdiction up to the Minimum Rate. This Top up Tax does not operate as a typical direct tax on income of an Entity. Rather it applies to the Excess Profits calculated on a jurisdictional basis and only applies to the extent those profits are subject to tax in a given year below the Minimum Rate. Rather than a typical direct tax on income, the tax imposed under the GloBE Rules is closer in design to an international alternative minimum tax, that uses standardized base and tax calculation mechanics to identify pools of low-taxed income within an MNE Group and imposes a co-ordinated tax charge that brings the Group's ETR on that income in each jurisdiction up to the Minimum Rate. The design of the GloBE Rules as a Top-up Tax facilitates the co-ordinated application of the GloBE Rules by ensuring that the aggregate amount of incremental tax payable under the rules in each jurisdiction does not cause the ETR to exceed the Minimum Rate. The design of the IIR and UTPR as Top-up Taxes, however, does not restrict a jurisdiction from legislating those rules under a corporate income tax system in its domestic law': OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, Paris 8 (2022), https://www.oecd.org/tax/beps/tax-challenges-arising-from-thedigitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf (accessed 19 Mar. 2022).

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The application of a top-up tax is to occur via four interlocking types of rules. Two of them are known as the Global Anti-Base Erosion (GloBE) rules[5] and include:

1) an income inclusion (IIR) rule to be applied by the state of the ultimate parent entity, an intermediate parent entity, or a partially owned parent entity (residence jurisdiction)[6]; and 2) an undertaxed payment rule (UTPR) to be applied by the state of a constituent entity – subsidiary or permanent establishment[7] – (source jurisdiction) in the event that the state of the parent entity does not apply a minimum effective tax rate.[8]

There are two additional complementary rules: 3) a subject to tax rule (STTR) to be applied by developing countries on gross income. They will be included in bilateral treaties and implemented if the state of the parent entity applies nominal corporate income tax rates below the STTR minimum rate to interest, royalties, and a defined set of other payments[9]; and 4) a qualified domestic minimum top-up tax is foreseen in the model rules as optional. The domestic top-up tax (DMTT) is a minimum tax included in the domestic law of a jurisdiction.[10] It can be described as a domestic switch over rule that allows a source state to collect the revenue that would otherwise be transferred to a residence jurisdiction. The DMTT is held by the OECD to be equivalent to the GloBE rules.[11]

2 Residence and Source

The design of the rules corresponds to a top-down approach that generally grants the priority of applying the IIR to the parent entities at the top of the ownership chain.[12] This prevails over the UTPR and grants primacy to the interests of the residence (capital-exporting) states.

Nonetheless, the UTPR brings symmetry to the international tax system. It grants rights to the source (capital importing) jurisdictions if the state of the parent entity is a low tax jurisdiction or has not joined Pillar Two and does not apply an IIR in either case. It can either be implemented as not allowing a deduction of costs paid to another entity abroad, via a top-up tax applicable on a resident taxpayer (a subsidiary) or on the permanent establishment situated in its territory.[13]

Moreover, the interests of source jurisdictions are granted primacy via an (optional) DMTT that has precedence over the IIR. Source jurisdictions have two possibilities. They can raise the effective tax rate to 15% and, in this manner, avoid shifting revenue to the parent entity jurisdiction. They can also not increase their effective tax rate to 15% but instead, levy a DMTT. The amount of this is more beneficial to the constituent entities and the MNE group (it is lower) than the application of the minimum ETR. The revenue concerning the DMTT belongs to the state that applies it.[14]

In the relation between a developing country[15] and a jurisdiction that does not fall in that category, the STTR is to be applicable before the IIR (and all of the others) and will be included in a bilateral tax treaty.

3 Combination of the Four Interlocking Types of Rules

The below examples illustrate a number of possible combinations of the four interlocking types of rules.

Notes

[5] OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution … , supra* n. 2, at 3; *See* Arts 2.1–2.6 of the Model rules: OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1.

[6] Article 2.1 of the Model rules: OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1.

[7] Article 1.3 of the Model rules: OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1, 'Constituent Entity A Constituent Entity is: (a) any Entity that is included in a Group; and (b) any Permanent Establishment of a Main Entity that is within paragraph (a)'.

[8] Article 2.4 of the Model rules: OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1.

[9] OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution …, supra* n. 2, at 3 and 5.

[10] 'Qualified Domestic Minimum Top-up Tax means a minimum tax that is included in the domestic law of a jurisdiction and that: (a) determines the Excess Profits of the Constituent Entities located in the jurisdiction (domestic Excess Profits) in a manner that is equivalent to the GloBE Rules; (b) operates to increase domestic tax liability with respect to domestic Excess Profits to the Minimum Rate for the jurisdiction and Constituent Entities for a Fiscal Year; and (c) is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary, provided that such jurisdiction does not provide any benefits that are related to such rules': OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1, at 64.

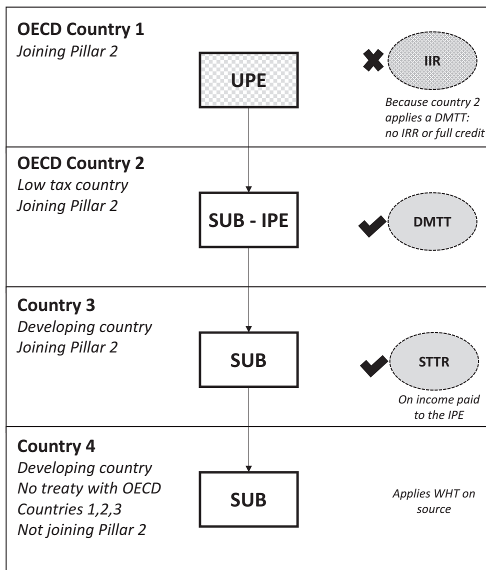
[11] OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1, at 64.

[12] *See* OECD, … *(Pillar Two) …, supra* n. 4, at 9.

[13] Article 2.4.1 of the Model rules: OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1: 'Constituent Entities of an MNE Group located in [insert name of implementing-Jurisdiction] shall be denied a deduction (or required to make an equivalent adjustment under domestic law) in an amount resulting in those Constituent Entities having an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction'.

[14] Michael Devereux, John Vella, and Heydon Wardell-Burrus, *Pillar 2: Rule Order, Incentives, and Tax Competition* (14 Jan. 2022). Oxford University Centre for Business Taxation Policy Brief, Available at SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4009002 (accessed 19 Mar. 2022). *See also* the Explanatory Memorandum of the European Commission, Proposal for a Council Directive on Ensuring a Global Minimum Level of Taxation for Multinational Groups in the Union, Brussels, 22 Dec. 2021 COM(2021) 823 Final, at 8, https://ec.europa.eu/taxation_customs/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf; Ana Paula Dourado, *Pillar Two Model Rules: Inequalities Raised by the GloBE Rules, the Scope, and Carve-Outs {pre-publication}*, 50(4) Intertax [pre-publication] 1–4 (2022), https://kluwerlawonline.com/journalarticle/Intertax/50.4%20[pre-publication]/TAXI2022035.

[15] *See* the definition of developing countries in the OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution … , supra* n. 2, at 5, https://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: developing countries are therein defined as those with a GNI per capita, calculated using the World Bank Atlas method, of USD 12 535 or less in 2019 to be regularly updated.

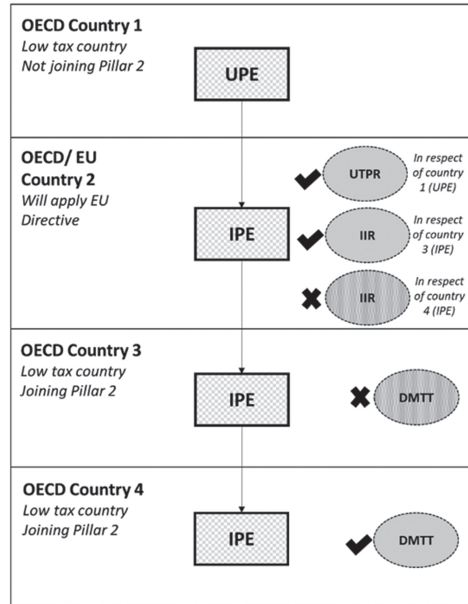


In this example 1, the STTR takes precedence but does not prevent developing country 4 from applying a withholding tax on source because it has not joined Pillar Two.

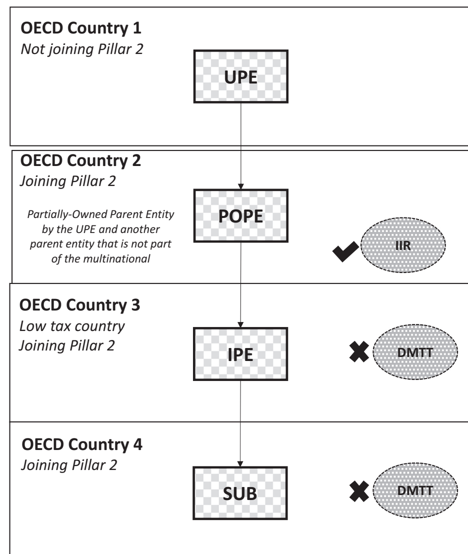
Moreover, it seems that the STTR does not prevent country 2 from applying a DMTT because calculation of the STTR mentioned previously takes place by reference to nominal tax rates whereas the DMTT calculation refers to the effective tax rate. In this example, the top-down approach that generally grants priority to the IIR and the parent entities at the top of the ownership chain does not apply. Moreover, any tax payable pursuant to a DMTT is taken into account in the computation, according to Articles 5.2.1-5.2.3, so as to give full credit in the GloBE top-up tax computation (see the commentaries to Articles 5.2.1-5.2.3: OECD Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global AntiBase Erosion Model Rules (Pillar Two), OECD, Paris, 2022, p. 118 https://www.oecd.org/tax/beps/tax-challenges-arising-from-thedigitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf).

In this example 2, the OECD countries 1, 3 and 4 are low-tax countries, and none of them is a member of the European Union. Country 1 is a low-tax country and did not join Pillar Two. The ultimate parent entity is situated therein. There are intermediate parent entities in all of the other three countries: The intermediate entity in country 4 is controlled by the intermediate entity in country 3, and the latter is controlled by the intermediate parent entity in the EU Member State, country 2.

The EU Member State (country 2) will apply a UTPR in respect of the ultimate parent entity in country 1 and an IIR in respect of the intermediate parent entity in country 3. This is because countries 2 and 3 did not opt for applying a DMTT.



In contrast, countries 2 and 3 will probably reduce the IIR to nil in respect of the intermediate parent entity in country 4 because the latter will apply a DMTT (see the commentaries to Article 5.2.3: OECD ... Commentary to the Global AntiBase Erosion Model Rules (Pillar Two), cit. p. 118.



In this example 3, the partially-owned parent entity located in country 2 and owning (directly or indirectly) an ownership interest in a low-taxed constituent entity located in OECD Country 3 shall pay a tax (due to the IIR) in an amount equal to its allocable share of the top-up tax of that low-taxed constituent entity for the fiscal year.[16]

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[16] Article 2.1.4., OECD Model Rules: Art. 2.1.4 shall not apply if the partially-owned parent entity is wholly owned (directly or indirectly) by another partially-owned parent entity that is required to apply a qualified IIR for that fiscal year. *See also* OECD, … *Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two) …*, *supra* n. 4, at 24 et seq.

The three examples above illustrate that the interlocking rules are applied bilaterally and depend: on the concrete location of each entity (identification of the low tax jurisdiction; location of the ultimate parent entity; location of one or more intermediate parent entities[17]; location of a partially owned parent entity[18]; location in a country joining or not joining Pillar Two); and on the specific ownership interests. Thus, the rule order and the interplay between residence and source jurisdictions can originate several combinations depending on the jurisdictions at stake and the ownership interests.

Finally, whenever an EU Member State comes into play, a harmonized regime will be applicable if a directive is approved.[19] The EU will in that case operate as a single jurisdiction for the purposes of Pillar Two and minimum taxation. EU Member States will implement an IIR and apply it to their parent companies in the event that subsidiaries or permanent establishments in other Member States are subjected to an effective tax rate below 15%.[20]

The UTPR is not applicable because the IIR is binding. This solution would benefit residence Member States (capital-exporting Member States) since they would receive the tax revenue that a source Member State forfeited by adopting an effective tax rate below 15%. Moreover, a controlled foreign company rule could still be applicable according to Articles 7 and 8 of the anti-tax avoidance directive[21] if the minimum effective tax rate is below the tax rate of the ultimate parent entity jurisdiction.

For the rest of the world as well as for the relationship between an EU Member State and a non-EU jurisdiction, the share of tax revenue among residence and source jurisdictions will depend on whether jurisdictions will join Pillar Two; whether they will raise the effective tax rate to 15%; whether they will opt for the DMTT; and whether a developing country will subscribe to Pillar Two.

Thus, because of the DMTT and the STTR, the rule order does not necessarily favour capital-exporting or capital-importing countries; the outcome will very much depend on the combination applicable to the concrete case. However, for those developing states with a few tax treaties, it will still be preferable not to sign the Pillar Two agreement because their national withholding taxes are higher than the 9% foreseen as the minimum tax rate for the STTR.[22]

4 Characterization of the GloBE Rules

The mechanisms established in the model rules are new and must be characterized as it is disputable whether they are anti-base erosion rules similar to others promoted by the Base Erosion and Profit Shifting (BEPS) Actions[23]; income taxes; or international alternative minimum taxes that are or are not to be included in the corporate income tax legislation.[24]

The focus herein will be on the characterization of the GloBE rules (the IIR and the UTPR), and the conclusions can be transposed *mutatis mutandis* to the STTR and the DMTT. There are four basic elements that can assist for characterizing these rules, specifically:

1) they introduce a top-up tax; 2) the top-up tax is imposed on profits arising in or paid to a jurisdiction whenever the effective tax rate applied that is determined on a jurisdictional basis is below the minimum rate[25]; 3) they introduce a global minimum corporate tax rate; and 4) they provide for a coordinated system of taxation intended to ensure that large MNE groups pay a minimum level of tax on the income arising in each of the jurisdictions where they operate.

It results from 1) and 2) that the IIR and the UTPR operate as cross-border switch-over rules. This is a mechanism similar to other rules such as: controlled foreign

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[17] According to the Model Rules (OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1): 'Intermediate Parent Entity means a Constituent Entity (other than a Ultimate Parent Entity, Partially Owned Parent Entity, Permanent Establishment, or Investment Entity) that owns (directly or indirectly) an Ownership Interest in another Constituent Entity in the same MNE Group'.

[18] According to the Model Rules (OECD, *Global Anti-Base Erosion Model Rules, supra* n. 1): a 'Partially-Owned Parent Entity means a Constituent Entity (other than a Ultimate Parent Entity, Permanent Establishment, or Investment Entity) that: (a) owns (directly or indirectly) an Ownership Interest in another Constituent Entity of the same MNE Group; and (b) has more than 20% of the Ownership Interests in its profits held directly or indirectly by persons that are not Constituent Entities of the MNE Group'. *See also* Art. 2.1. of the Model Rules.

[19] European Commission, Proposal for a Council Directive on Ensuring a Global Minimum Level of Taxation for Multinational Groups in the Union, Brussels, 22 Dec. 2021 COM(2021) 823 Final, https://ec.europa.eu/taxation_customs/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf (accessed 19 Mar. 2022).

[20] Ana Paula Dourado, *The EC Proposal of Directive on a Minimum Level of Taxation in Light of Pillar Two: Some Preliminary Comments*, 50(3) Intertax 200–204 (2022), https://kluwerlawonline.com/journalarticle/Intertax/50.3/TAXI2022029 (accessed 19 Mar. 2022).

[21] Council Directive (EU) 2016/1164 of 12 Jul. 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, *OJ L 193, 19 July 2016,* at *1*–14, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L1164&from=EN.

[22] OECD Statement on a Two-Pillar Solution … , *supra* n. 2, at 5; Dourado, *supra* n. 14, at 1–2.

[23] V. Chand, A. Turina & K. Romanovska, *International – Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges*, 14(1) World Tax J. 1–31 (2022).

[24] *See* OECD, … *Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two) …, supra* n. 4, at 8.

[25] OECD, Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, OECD, 2021, at 7.

companies (CFC) rules[26]; switch-over rules applied in residence states from exemption to imputation (thus, taxation and a credit if necessary)[27]; anti-hybrid rules (primary rule (non-deduction) or defensive rule (requiring the deductible payment to be included in income; or denying the duplicate deduction depending on the nature of the mismatch).[28]

These features and conclusions are also broadly applicable to the STTR and the DMTT even if they have some divergent characteristics. For example, the former is calculated on the basis of nominal tax rates and the latter on the basis of excess profits of the constituent entities located in the jurisdiction.

5 Comparison to CFC Rules

The IIR has similarities with CFC rules.[29] The latter deny deferral of taxation on income accrued to a CFC or a similar entity that would not be submitted to taxation in the residence country. They are often designed as an exception to a deferral and generally apply to income that is not genuine business income and income derived by the CFC subject to low tax rates in the foreign jurisdiction.[30]

CFC rules have been justified as a means to protect the tax base and by anti-avoidance purposes, and the process towards territoriality by many OECD Member countries has stressed the anti-avoidance purposes. They intend to prevent the use of low-tax jurisdictions with the objective of shifting income from the jurisdiction of the state of residence to the state of the subsidiaries or permanent establishments.[31] The anti-avoidance purpose is often related to a substance-based analysis that examines whether the CFC engaged in substantial activities. Genuine economic activities will then benefit from a carve-out.[32]

As contended previously by this author, CFC rules in the Base Erosion and Profit Shifting (BEPS) initiative are an element of tension between residence and source countries if the latter have competitive tax policies aimed at attracting foreign investment.[33] Moreover, they have not been as effective as was expected.[34]

Differently from CFC rules, an IIR is applicable even if there is a distribution of income. It is a top-up tax on the profits accrued to a in-scope entity in the low tax source jurisdiction and will be applied on a routine basis. Therefore, its objective is not only to neutralize the taxpayer's (tax) advantage in shifting investment to a low tax jurisdiction but to also neutralize any competitive advantage by the other jurisdiction. CFC rules also neutralize an attractive regime in another state.[35] However, they primarily counterbalance the taxpayer's advantage in shifting profits abroad because this only occurs if there is no distribution of income.

Similar to CFC rules, the IIR protects the tax base of the residence country. Additionally, the substance-based carve-out in the GloBE rules introduces an element of avoidance similar to the CFC carve-out for genuine economic activities (when such a carve-out exists).

However, the GloBE rules' top-up taxes are based on a coordinated system of calculating the effective tax rate (relying on international accounting standards), and fall on the income of the in-scope entity located in a foreign low taxed jurisdiction. In contrast, the CFC and the other existing switchover rules are calculated and implemented on the basis of domestic tax bases and rates. The STTR is more similar to the existing switchover rules because it relies on nominal tax rates determined by each state.

Additionally, it has been contended that CFC rules also indirectly protect the interests of the source states by making it unattractive to transfer profits to a haven.[36] However, they did not factually contribute

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[26] *See* OECD, Designing Effective Controlled Foreign Company Rules, Action 3–2015 Final Report, 2015, https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1647888834&id=id&accname=guest&checksum=2FE018DC79326A903886C968E3E5DCEA (accessed 19 Mar. 2021), e.g., Ch. 2.

[27] An example of switchover rules is discussed in: Haribo Lakritzen Hans Riegel BetriebsgmbH and Österreichische Salinen AG *v.* Finanzamt Linz, Joined Cases C-436/08 and C-437/08, paras 176–181.

[28] 'The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule requiring that the deductible payment be included in income or denying the duplicate deduction depending on the nature of the mismatch': at 12; *See also* e.g., at 34.

[29] On similarities and differences between the GloBE rules and CFC rules: Johanna Hey, *The 2020 Pillar Two Blueprint: What Can the GloBE Income Inclusion Rule Do That CFC Legislation Can't Do?,* 49(1) Intertax 9–13 (2021), https://kluwerlawonline.com/journalarticle/Intertax/49.1/TAXI2021002 (accessed 19 Mar. 2022).

[30] *See* the reference to different types of CFC rules in: Matthias Dahlberg & Bertil Wiman, *General Report*, Cahiers de Droit Fiscal International, IFA 2013, Copenhagen Congress, Vol.98ª, 27–41 (2013); Ana Paula Dourado, *The Role of CFC Rules in the BEPS Initiative and in the EU*, (3) BTR, 343, 353 (2015); *see also* Georg Kofler, *CFC Rules*, in *Common Corporate Consolidated Tax Base* 728 (M. Lang, P. Pistone, J. Schuch & C. Staringer eds, Linde Verlag Wien 2008).

[31] Dourado, *supra*, n. 30, at 344–345.

[32] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3* … cit., *supra* n. 26, at 47–49.

[33] Dourado, *supra* n. 30, at 342; OECD, *Designing Effective Controlled Foreign Company Rules, Action 3* … cit., *supra* n. 26.

[34] OECD, *Action Plan on Base Erosion and Profit Shifting* 16 *(BEPS Action Plan*), 2013, http://dx.doi.org/10.1787/9789264202719-en (accessed 19 Mar. 2022).

[35] Dourado, *supra* n. 30, at 341.

[36] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3–2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris 13, https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1647718097&id=id&accname=guest&checksum=D266999C321E668091CF4123CB5C3350 (accessed 19 Mar. 2022); Dourado, *The Role of CFC Rules* … , *supra* n. 30, at 342.

to the increase of the tax rate in the source jurisdiction. Otherwise, there would be no need for Pillar Two and the international coordination of minimum tax rates.

6 Comparison to the GILTI and the BEAT

In order to characterize the GloBE rules, it is also important to compare them to the two measures adopted in the Tax Cuts and Jobs Act (TCJA) on 22 December 2017: the global intangible low-taxed income (GILTI), and the US base erosion and anti-abuse tax (BEAT).[37] The objectives of both measures are to prevent base erosion and profit shifting from the United States. This could be a consequence of the exemption regime applicable on earnings from active businesses of US firms' foreign subsidiaries and adopted by the TCJA. An exemption applies even if the earnings are repatriated.

As mentioned, one of the measures against base erosion and profit shifting is the GILTI. It is a deemed amount of income derived from controlled foreign companies' affiliates of US companies from intangible assets such as patents, trademarks, and copyrights, and in which a US person is a 10% direct or indirect shareholder. It is computed by determining a CFC's taxable income (or loss) as if the CFC was a US person. The Tax Cuts and Jobs Act imposes a new 10.5% minimum tax on the GILTI. It is intended to prevent erosion of the US tax base by discouraging multinational companies from shifting their profits on easily moved assets, such as intellectual property (IP) rights, from the United States to foreign jurisdictions with tax rates below those of the United States.[38] It is easy to conclude that the IIR and the substance-based income exclusion are inspired by the GILTI.

In turn, the BEAT functions as a corporate minimum tax of 10% applying to certain multinational companies that make 'base erosion payments' to foreign related parties. It adds back all related-party payments, such as interest and royalties, except those associated with the cost of goods sold. It recalculates corporate tax liability at half the regular corporate tax rate with additional tax being due if 10% of the modified taxable income exceeds 20% of the corporate tax base.[39]

There is a legal fiction according to which interest and royalty payments to foreign parties are tax planning tools to reduce corporate income tax in the United States. A conclusion is easily ascertainable that the UTPR and the substance-based income exclusion are inspired by the BEAT.

Both the GILTI and the BEAT are minimum taxes applying to certain multinational corporate taxpayers. Their purpose is to discourage US and foreign corporations from avoiding tax liability by shifting profits out of the United States.

7 The GloBE Rules Structured Through the Use of Legal Fictions vs. Prevention of Avoidance

The IIR and the UTPR are described by the OECD as anti-base erosion rules.[40] This reference can be interpreted in two related ways. The first is to interpret them as legal fictions (1), and the second is to conceptualize them as rules with an objective of preventing avoidance and similar to CFC rules (2).

Legal fictions intend to take one rule that is connected to a specific fact and apply it to another fact.[41] For example, the top-up tax is formally levied on the resident taxpayer (the ultimate parent entity) as if a company's investment in a low tax jurisdiction via an autonomous subsidiary or permanent establishment results in a parent entity's tax base erosion; the top-up tax pretends that an effective tax rate lower than 15% corresponds to a base erosion of the parent entity. This is so, even if the low tax is applied on an autonomous taxpayer (a subsidiary or a permanent establishment), and even if the tax base of this autonomous taxpayer has been determined according to internationally acknowledged transfer pricing rules.

As anti-avoidance rules, the four interlocking rules would function as irrebuttable presumptions of avoidance taking into account the way that they are drafted. In that case, the problems concerning the compatibility of CFC rules with tax treaties and assuming that the latter are drafted as anti-avoidance rules containing an irrebuttable presumption of abuse would also accord with the GloBE rules. The STTR will be included in bilateral treaties and any incompatibilities will be eliminated.

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[37] Marc M. Levey, Alexandra Minkovich & Joshua D. Odintz, *Taking Stock of US 'Tax Reform' as the Dust Settles*, 46(4) Intertax 352–355 (2018).

[38] The United States still taxes the income from passive investments of foreign subsidiaries '… US business must include GILTI in its gross income annually. GILTI is calculated as the total active income earned by a US firm's foreign affiliates that exceeds 10% of the firm's depreciable tangible property. A corporation (but not other businesses) can generally deduct 50% of the GILTI and claim a foreign tax credit for 80% of foreign taxes paid or accrued on GILTI. Thus, if the foreign tax rate is zero, the effective US tax rate on GILTI will be 10.5% (half of the regular 21% corporate rate because of the 50% deduction). If the foreign tax rate is 13.125% or higher, there will be no US tax after the 80% credit for foreign taxes', https://www.taxpolicycenter.org/briefing-book/what-global-intangible-low-taxed-income-and-how-it-taxed-under-tcja.

[39] Ana Paula Dourado, *The US Base Erosion and Anti-Abuse Tax, and the EU Responses*, 46(4) Intertax 266 (2018).

[40] The Global anti-Base Erosion Rules (GloBE) rules: OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution …, supra* n. 2, at 3.

[41] Karl Larenz & Claus-Wilhelm Canaris, *Methodenlehre der Rechtswissenschaft*, 3 Auf., Berlin, Heidelberg 83 (1995).

Nevertheless, if the conclusion is that the IIR and the DMTT are irrebuttable presumptions of abuse, they would be incompatible with the freedom of establishment in the European Union, because they would constitute obstacles (restrictions) to the exercise of that fundamental freedom. This is valid even if they are not discriminatory (i.e., even if they are applicable to both cross-border and domestic transactions).[42] Thus, the proposal for a directive would not be compatible with Article 49 of the Treaty on the Functioning of the European Union.

However, the four interlocking rules are not anti-avoidance rules because irrebuttable presumptions of avoidance rely on a likelihood of avoidance, and the four interlocking rules do not. If the IIR and the other interlocking rules are to be considered as anti-base erosion rules, they are legal fictions as they change the 'legal truth' that is granted by the international rules on the allocation of taxing rights and the tax base. A legal fiction is different from a presumption because the former does not rely on a likelihood. Legal fictions allow the extension of the law to situations that were not initially foreseen and introduce new ethical and social values into the legislation.[43] In the case of the four interlocking rules, ethical and social values are related to a minimum effective tax rate applied to the in-scope MNEs.

Moreover, those rules are applicable even if there is no aggressive tax planning. As developed in the context of the BEPS Project, aggressive tax planning is related to a concept of double non-taxation, it can either result from tax avoidance or legal gaps raised by the interaction of two or more tax legislations (disparities).[44] The idea that tax treaties also prevent non-taxation is related to the prevention of tax evasion and avoidance.[45]

Additionally, the four interlocking rules are applicable in the following situations: 1) even if value creation has been correctly allocated according to transfer pricing rules; 2) even if CFC rules and other anti-base erosion rules preventing double non-taxation are applicable;3) even if any specific or general anti-abuse rules are applicable.

This means that the GloBE rules are applicable even if there is no aggressive tax planning (tax avoidance or disparities); and, if there is, they apply even if measures were taken to eliminate it. They are also pertinent when there is low or zero taxation in one of the jurisdictions even if there is high taxation in the other jurisdictions.

As mentioned above, there are multiple possible combinations of the GloBE rules with the DMTT and the STTR, including the fact that not all jurisdictions in the world will subscribe to Pillar Two. Thus, although the four interlocking rules are based on international coordination of assessing tax rates, they contribute to establishing a minimum tax rate bilaterally. This bilateral effect is then multiplied. For example, all MNEs in the scope of Pillar Two and subject to an effective tax rate that is lower than 15% in a specific source jurisdiction will be subject to an IIR in the ultimate parent entities' jurisdictions (joining Pillar Two).

This multiplication effect is symmetric to a certain extent to that resulting from the most favourable national treatment (Article 1.1) of the General Agreement of Trade and Tariffs (GATT). The latter operates multilaterally: a more favourable (bilateral) customs duty is extended to all GATT Members and has led to the decrease of customs duties. In contrast, the IIR together with the UTPR, the DMTT, and the STTR aim to stop tax competition below a certain tax rate.

Differently from the rules recommended by the BEPS Actions as well as the GILTI and the BEAT, the GloBE rules are to be introduced via a coordinated system of taxation and aim at a coordinated minimum tax rate.

8 The GloBE Rules as New Taxes in light of Article 2(2) of the OECD Model Convention

The GloBE rules must be assessed in light of Article 2 (2) of the OECD Model Tax Convention. This is because they are announced as top-up taxes, and their purpose is to coordinate a minimum tax rate.

According to Article 2(2) of the OECD Model Tax Convention, 'taxes on income and capital are taxes imposed on total income or elements of income, or total capital or elements of capital, including taxes on gains from the alienation of movable or immovable property … as well as taxes on capital appreciation'. Furthermore, it has been contended that the term taxes refers to 'compulsory, unrequited monetary payments to government units', but details are to be ruled by domestic laws.[46]

The OECD Model Tax Convention Commentary includes accessory duties or charges to taxes in the meaning of tax in Article 2 (2) but excludes fees, charges, and social security charges from that meaning. The method of levying taxes is not relevant and encompasses, among

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[42] *See* the combination of: Case C-196/04, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, 12 Sep. 2006, ECLI:EU:C:2006:544, paras 50-51; and Case C-126/10, Foggia - Sociedade Gestora de Participações Sociais v Secretário de Estado dos Assuntos Fiscais, 10 Nov. 2011, ECLI:EU:C:2011:718.

[43] Ana Paula Dourado, *O Princípio da Legalidade Fiscal, Tipicidade, Conceitos Jurídicos Indeterminados e Margem de Livre Apreciação*, Almedina, Coimbra 603–607 (2007).

[44] Ana Paula Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and* 6, 43(1) Intertax 42–57 (2015).

[45] Werner Haslehner, *Introduction,* in *Klaus Vogel on Double Taxation Conventions* 25 (Reimer & Rust eds, 5th ed., Wolters Kluwer 2022), ns. 30–31.

[46] Roland Ismer & Alexander Blank, *Klaus Vogel on Double Taxation Conventions, supra* n. 44, at 165–166 (no 24); and also: at 166, no 26 (*See also* at 165–177, spec. nos 23–55).

others, a direct assessment or deduction at the source, surtaxes or surcharges, and additional taxes.[47]

The IIR, the UTPR, the STTR, and the DMTT are 'compulsory, unrequited monetary payments to government units that are levied on income or capital. They do not rely on presumptions concerning taxpayers' behaviour nor do they depend on it. Instead, they rely on legal fictions which make them compulsory. These legal fictions are instrumental to the purpose of curbing tax competition as such.

The method of levying those monetary payments is not relevant for the purposes of Article 2 (2). Thus, the fact that they are top-up taxes or that they could be considered extraordinary taxes because of the way in which they are levied, is not relevant for excluding them from the category of taxes on income or capital.

Thus, if the four interlocking rules are taxes on income or capital, they are in the scope of bilateral tax treaties (Article 1 of the OECD Model Convention) and are incompatible with the allocation of taxing rights as defined in Articles 7 and 10–13 (at least) of the OECD Model Tax Convention. Because these taxes fall on the income of residents in other contracting states or permanent establishments abroad, the savings clause foreseen in Article 1 (3) of the OECD Model Convention (2017) would not be applicable.

A contracting state cannot claim that the allocation of taxing rights as defined in the OECD Model Tax Convention is overruled by a top-up tax because the other contracting state does not apply a minimum effective tax rate of 15%. This overrules the allocation of taxing rights agreed between the contracting states. Additionally, the application of the GloBE rules, the DMTT, or the STTR is not caused by the taxpayer and tax planning behaviour, Therefore, they also cannot be justified by that (non-existent) behaviour. Applying such a top-up tax without amending the bilateral tax treaties is not compatible with Article 31, paragraph 1 of the Vienna Convention on the Law of Treaties: the text of the treaties, the ordinary meaning of its terms, its purpose, and a bona fide interpretation.[48]

9 Concluding Remarks

Since the BEPS Project began in 2012, broad concepts such as aggressive tax planning and anti-base erosion measures have increased the confusion between measures that target taxpayers' abusive (or avoidance) behaviour and measures that target the harmful tax competition among states.

Avoidance or abuse requires an assessment of the taxpayer's business purpose or valid commercial reasons, whether presumed or not. In contrast, measures such as the IIR, the UTPR, the DMTT, and the STTR imply a reaction to tax competition by another state that is independent of the purpose or reasons. Thus, the measures to implement minimum taxation are unrelated to avoidance behaviour.

Ana Paula Dourado
Editor-in-Chief

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[47] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Paris, https://doi.org/10.1787/mtc_cond-2017-en:Commentary, on para. 1, n.º 2.

[48] Haslehner, *supra* n. 45, at 45–50, spec., nos. 95–102.