EDITORIAL

Pillar Two Model Rules: Inequalities Raised by the GloBE Rules, the Scope, and Carve-Outs

1 Minimum effective tax rate and switch-over rules

It is officially claimed that the purpose of Pillar Two and its model rules is to establish a minimum level of tax on multinational groups (MNEs) that are encompassed by its scope.[1] The minimum level of tax should correspond to an effective tax rate (ETR) of 15% to be applied by the jurisdiction in which the constituent entity is located[2] and, in the event that the jurisdiction fails to do so, a mechanism of switch-over taxes is put into force by another jurisdiction. This is the general regime.

This mechanism requires that other jurisdictions will ensure that the 15% ETR is implemented via an income inclusion rule (IIR) applied to an ultimate parent entity (UPE) in respect of its low taxed constituent entities; and through an undertaxed payment rule (UTPR) operating as a back-stop mechanism, applied to a subsidiary, a permanent establishment or another constituent entity of the group.[3] This rule order (the IIR first; the UTPR subsidiarity) is diverse when other mechanisms come into play: that is the case of the subject-to-tax rule (STTR) and the qualified domestic-top-up tax (DMTT). Some problems raised by the interaction of these mechanisms, the option to decrease the threshold applicable to the in-scope MNEs, and the substance-based carve-outs are examined below.

2 The STTR and developing countries

Developing countries are entitled to apply a minimum nominal rate of 9%, using a subject-to-tax rule (STTR), to interest, royalties, and other payments. It is applicable in the case that the Inclusive Framework (IF) Members who are recipients of that income submit it to a nominal tax rate below the STTR minimum rate. The STTR also operates as a switch-over tax but on a gross basis and takes precedence over the IIR and the UTPR as it is creditable as a covered tax in the parent entity jurisdiction under the Global Anti-Base Erosion (GloBE) rules.[4] The fact that the STTR takes precedence over the IIR and the UTPR is positive in terms of international tax justice. However, it will not allocate sufficient tax revenue to developing countries, among other reasons, due to the substance-based carve outs and to the fact that base erosion and profit shifting (BEPS) are still major challenges there.

Moreover, the OECD/G20 *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* makes reference to a multilateral instrument 'to facilitate the swift and consistent implementation of the STTR' in bilateral tax treaties.[5] Whether or not it is a paradox, the STTR may lead to lower withholding tax rates than those that have been applied thus far in those countries' unilateral rules. If the application of the STTR is made conditional upon the conclusion of bilateral tax treaties by the interested jurisdictions – as it seems to be the case – , it will have a negative effect in the revenues allocated to developing countries. Under tax treaty rules, they will have to forfeit relevant taxing rights as source jurisdictions in favour of the jurisdictions of the parent entities. A multilateral instrument not related to 'covered' bilateral tax treaties, or autonomous bilateral tax treaties, with the specific object and purpose to implement Pillar-Two, and including the STTR, would be a preferable solution.

Notes

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), Executive Summary (and 60: definition of minimum rate), https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-theeconomy-global-anti-base-erosion-model-rules-pillar-two.htm (accessed 22 Feb. 2022).

2 Location of an entity and a permanent establishment is determined according to Art. 10.3 of the model rules: *ibid.*, at 67–68.

3 OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* 4 (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 (accessed 20 Feb. 2022). *See also* L. de Broe & M. Massant, *Are the OECD/G20 Pillar Two GloBE-Rules Compliant With the Fundamental Freedoms?*, 30(1) EC Tax Rev. 88–89 (2021).

4 OECD, *supra* n. 3, at 3.

5 *Ibid.*, at 3 and 5.

In order for developing countries to benefit from the STTR, they would also need to implement the domestic measures recommended by the BEPS Project[6] to curb the erosion of tax bases. Furthermore, those developing countries with a relevant tax treaty network, would need to join the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.[7]

Otherwise, the gross taxation of interest, royalties, and other payments under the STTR is not enough to compensate the loss in corporate income tax revenue via the deduction of costs as a result of profit shifting. Moreover, and in any case, it will be very difficult for tax authorities in developing countries to manage to apply the transfer pricing rules in light of value creation as recommended by BEPS Actions 10–13.[8] All in all, the STTR does not seem to be appropriate to increase tax revenue in developing countries.

3 Tax competition and the DMTT

The alleged purpose of Pillar Two and the model rules is to create a floor in tax competition.[9] Whether the purpose will be achieved is more dubious, to begin with, because the subjective scope is limited to some MNEs (Article 1.1 of the model rules). There is also a carve-out on the objective scope (a carve-out excluding some types of submitted income: Article 5.3 of the model rules) that affords some opportunity for tax competition.

Moreover, the qualified domestic top-up tax (DMTT) also creates advantageous circumstances for tax competition. It allows source states to apply general or specific tax rates that are lower than the minimum ETR of 15%. The DMTT is to be charged and collected in a jurisdiction – the same jurisdiction – in which the low-level taxation occurred (on any low-taxed constituent entities of the MNE group located in a jurisdiction). This is different than the previously mentioned interlocked rules that operate via compensation as a result of the non-compliant jurisdiction.

Because the DMTT is levied by the 'non-compliant' source jurisdiction itself (a jurisdiction that does not opt to apply minimum ETR),[10] it reduces the efficacy of the IIR and the UTPR. As mentioned before, by applying the compensatory DMTT, it will be entitled to collect the tax revenue instead of forfeiting it to the state of the parent entity. Whereas the combination between the IIR and the UTPR and the primacy of the former, could foster source jurisdictions to increase their ETR, the DMTT changes this. It will continue to promote tax competition[11] and the reduction of corporate income tax rates in source jurisdictions, because the amount of the DMTT is more beneficial to the constituent entities and the MNE group (it is lower) than the application of the minimum ETR.[12] Moreover, the DMTT does not preclude the source jurisdiction to be ETR 'non-compliant' in respect of specific investment or constituent entities (see Article 10 of the Proposal for a Directive on minimum taxation),[13] and to apply an IIR or a UTPR concerning income not submitted to the minimum ETR in another jurisdiction that does not opt for a DMTT. This could be the case of preferential tax zones within one jurisdiction. In other words, a jurisdiction can be ETR non-compliant, apply a DMTT, and at the same time neutralize non-compliance by other jurisdictions that do not apply a DMTT.

Thus, if source jurisdictions opt to implement the DMTT, they will not increase the ETR to a minimum of 15%. The DMTT can be interpreted as the price to be paid under Pillar Two for avoiding the shifting of tax revenue to parent entities' jurisdictions.

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6 OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013), http://dx.doi.org/10.1787/9789264202719-en (accessed 22 Feb. 2022).

7 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (accessed 22 Feb. 2022). *See also* R. Szudoczky & D. Blum, *Unveiling the MLI: An Analysis of Its Nature, Relationship to Covered Tax Agreements and Interpretation in Light of the Obligations of Its Parties*, International and EU Tax Multilateralism, Challenges Raised by the MLI, 125 et seq. (A. P. Dourado, ed., IBFD 2020); L. E. Schoueri & G. Galdino, *Obligations to MLI Non-signatories Within the Inclusive Framework*, International and EU Tax Multilateralism (2020), cit., 161 et seq.; R. Prokisch & F. Souza de Man, *Multilateralism and International Tax Law: The Interpretation of Tax Treaties in Light of the Multilateral Instrument*, International and EU Tax Multilateralism 199 et seq (2020), cit.

8 *See* the UN guidance on the application of transfer pricing in Developing countries: *United Nations Practical Manual on Transfer Pricing for Developing Countries* (2017), https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-03/Manual-TP-2017.pdf (accessed 22 Feb. 2022).

9 *See* OECD, *supra* n. 1.

10 *See* the definition of Qualified Domestic Minimum Top-Up Tax, in: OECD, *supra* n. 1, at 64.

11 Michael Devereux, John Vella & 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 22 Feb. 2022).

12 *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 (accessed 22 Feb. 2022).

13 European Commission, Proposal for a Council Directive on Ensuring a Global Minimum Level of Taxation, *supra* n. 10.

4 Covered MNEs and the case for lowering the threshold

GloBE rules apply to 'members of an MNE Group that has an annual revenue of 750 million € or more in the consolidated financial statements of the ultimate parent entity in at least two of the four fiscal years immediately preceding the tested fiscal year' (Article 1.1 of the model rules). This threshold and the manner in which it is determined cross-refers to the country-by-country (CbC) reporting obligations under BEPS Action 13.[14] This makes it less complicated for MNEs in terms of compliance costs: those that are covered by CbC reporting obligations are also those that are subject to minimum taxation.[15]

This solution raises observations from the perspective of its efficacy and from a legal viewpoint. First, since the threshold concerning minimum taxation is related to CbC reporting obligations, it will be difficult to reduce it unless the CbC reporting obligation threshold itself is reduced. A threshold regarding consolidated financial accounts and other compliance costs can be justified in the context of the principle of practicability. It is assumed that compliance costs can be more easily borne by larger companies. Moreover, according to the OECD, this revenue threshold is estimated to cover over 90% of the global corporate income tax base.[16]

It is sensible to accept that these figures justify disregarding other MNEs with a lower ability to pay. It can also be assumed, that no issues of discrimination in national constitutions and Article 24, paragraph 1 of the OECD Model Convention are relevant. In case of doubt, jurisdictions would be sovereign to apply the minimum taxation to other MNEs. In fact, according to the Statement on a Two-Pillar Solution, '[c]ountries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold'.[17]

However, no reference is made to the UTPR, the DMTT, or the STTR. In case some countries would apply the IIR below the EUR 750 million threshold, the margin for source countries to grant incentives to MNEs that do not reach the threshold would be reduced. In the event that they do, parent entity jurisdictions could apply an IIR, and they could not reciprocate as source jurisdiction, applying a UTPR, DMTT or STTR. Furthermore, in such a case, the IIR would duplicate the role played by controlled-foreign companies (CFC) rules and grant an advantage to the parent entity jurisdictions in terms of revenue collection.

It is to be noted that no reference is made to the necessity of a bilateral tax treaty in the case that the IIR is applied to MNEs headquartered in a specific state and not meeting the threshold. However, the introduction of an IIR in these cases should require a bilateral tax treaty in order to be compliant with Articles 7 and 23 of the OECD Model Convention.

The Statement on a Two-Pillar Solution grants a margin of freedom to the European Union (EU) if it would decide to reduce the threshold in its proposal for a directive for the purposes of applying the IIR. However, if it did so, it would be dubious whether it would be entitled by the model rules to lower the threshold for the DMTT or the UTPR or even if there would be an interest in doing so.

Nevertheless, in general, lowering the thresholds for the purpose of the application of a DMTT, a UTPR, or a STTR should also be possible under bilateral tax treaties in order to avoid shifting revenue to the parent entities' jurisdictions.

The mechanisms chosen by the model rules to achieve the objective of minimum taxation involve the coordination of ETRs in the parent entities' and the source jurisdictions, and corresponding compensatory taxes. Thus, expanding the scope of the model rules also involves coordination. Reducing of the EUR 750 million threshold is a way of expanding the scope.

5 Substance-based carve outs, developing countries and emerging economies

The model rules also provide a formulaic substance-based carve-out: an income-exclusion amount for the jurisdiction to determine the excess profit and computing the top-up tax. It comprises a payroll carve-out and a tangible asset-carve out (the above mentioned Article 5.3 of the model rules).

If substance-based carve-outs are also applicable to investments in developing countries, the purpose of protecting the latter from pressure to grant tax holidays[18] is significantly reduced. In fact, developing countries are in need of brick and mortar industries for

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[14] OECD, *supra* n. 3, at 4.

[15] https://www.oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf, in no. 5, at 2 (accessed 22 Feb. 2022).

[16] *Ibid.*

[17] OECD, *supra* n. 3, at 4.

[18] On the topic, *see* e.g., IMF, *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment* (Oct. 2015), https://www.imf.org/external/np/g20/pdf/101515.pdf (accessed 22 Feb. 2022); also claiming that tax incentives in developing countries do not necessarily result in more foreign direct investment: Y. Brauner, *The Future of Tax Incentives for Developing Countries*, in *Tax, Law and Development* 25 et seq. (Y. Brauner & M. Stewart eds, Elgar 2013). For a critical analysis of the substance-carve-out in Pillar Two, see:L.E. Schoueri, Some Considerations on the Limitation of Substance-Based Carve-Out in the Income Inclusion Rule of Pillar Two, 75 (11/12) Bull. Intl. Taxn. 545 - 547 (2021), Journal Articles & Opinion Pieces IBFD (accessed 22 Feb. 2022).

which labour and tangibles are crucial factors. This means that the situation in some developing countries would not change radically with the current model rules.[19]

A different issue is raised by the inclusion in the eligible tangible assets of natural resources and licences or similar arrangements from the government for the use of immovable property or exploitation of natural resources. The fiscal regime of arrangements concerning the use and exploitation of natural resources is, as a rule, concluded in bilateral contracts between the company and the relevant jurisdiction. The inclusion of the natural resources industry in the model rules and, more than that, in the substance-based carve-outs, will reduce tax revenue in natural resources jurisdictions, create complexity in the negotiation of those fiscal regimes, and in determining what taxes are covered by the model rules.

It would have been preferable to exclude this industry from the model rules, separately reform the transfer pricing rules applicable to it, and renegotiate the allocation of taxing rights in favour of the natural resources jurisdictions.

Research and development industries, in contrast, are attracted by emerging economies and will be encompassed with the GloBE rules, which means priority will be granted to the IIR, and there will be an increase of tax revenue in parent entities' jurisdictions.

Amid the many questions that the new regime is posing to tax professionals, two of them relate to the margin left to tax competition (and tax planning), on the one hand, and to tax incentives, on the other hand. Notwithstanding the Pillar Two regime, new forms of incentives will have to be granted by jurisdictions around the world that still want to attract the in-scope MNEs. Shifting from tax exemptions, accelerated depreciation and amortization, low rates, and any other tax incentives to direct subsidies or incentives via social security taxes can be accomplished by rich economies and welfare states to attract investment. Developing and emerging economies, in contrast, are not sufficiently strong or organized to provide such measures. Therefore, the STTR will prove to be insufficient for increasing international tax justice.

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[19] Against eliminating tax incentives in developing countries blindly: T. Dagan, *Brics, Theoretical Framework and the Potential of Cooperation, in BRICS and the Emergence of International Tax Coordination* 20–23 (Y. Brauner & P. Pistone eds, IBFD 2015).