Editors:
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Global Minimum Taxation?

An Analysis of the Global Anti-Base Erosion Initiative

IBFD Tax Research Series
Volume 4

Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative

Why this book?

The Global Anti-Base Erosion (GloBE) proposal entails what may constitute the greatest shift in the international tax regime since its inception. GloBE is meant to focus on the "remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to 'tax back' where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation". First proposed in early 2019, this corollary to the BEPS Project – sometimes referred to as "BEPS 2.0" – has been in the international spotlight and pressed ahead with unprecedented speed. This book addresses the ongoing debate surrounding convergence towards global minimum taxation heralded by the proposed GloBE framework and connected rules in light of the specifications offered by the October 2020 Pillar Two Blueprint Report. It covers not only the design and technical aspects of the Pillar Two package, addressing in depth each of the proposed rules (income inclusion, undertaxed payments, switchover and subject-to-tax), but also their interaction and certain overarching issues such as the determination of the minimum effective tax rate and the design of a global tax base. Furthermore, the book approaches the proposed rules dynamically, setting them against the backdrop of key legal and policy frameworks, such as: tax treaties, transfer pricing, EU law and US rules, such as GILTI and BEAT. Then, the book considers broader policy issues concerning the prospective implementation of the proposed rules, also by providing a specific focus on the challenges and opportunities for developing countries. By way of conclusion, the volume addresses the interaction between the debates on Pillar Two and Pillar One, including the potential for simplification of the proposed rules. Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative constitutes essential reading for practitioners, students and policymakers, trying as it does to bring together the two complementary needs of ensuring the most up-to-date and topical coverage of this momentous turning point in international taxation with the necessary depth of analysis and the "big picture" view that should always inspire any research pursuit.

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Preface

It is my pleasure to write the preface for this book, the fourth in the IBFD Tax Research Series.

The IBFD Tax Research Series was launched in 2013. The aim of the series is to provide highly technical books on topics of current relevance in the international tax community. In doing so, the Series plays a vital role in fulfilling IBFD's mission: to spread the word of international taxation to every corner of the world.

A distinct feature of the Series is that each book is written and edited entirely by IBFD's in-house tax experts. This brings rich flavour to the work, taking in expertise across a wide range of subject areas, countries and regions. This particular book is especially notable for having been written and edited by IBFD's two main research departments: the IBFD Knowledge Centre and IBFD Academic. The output speaks for itself: a blend of rich tax technical insight from both a practical and an academic perspective.

For anyone involved in the world of taxation, the past few years have been nothing short of frenetic. For one thing, the BEPS Project has led to tax reform on a grand scale, not only at the national level (witness, for example, the raft of domestic tax law reforms instituted in many countries), but also at the international level (for example, via the OECD Multilateral Instrument).

And yet, there is more to come: the current OECD proposals (Pillars One and Two) assure us of further displacement of previously settled norms.

That is where this book comes in. As we approach the certainty of yet more change, IBFD is, once again, pressed into service to perform its time-honoured role: to educate, inform and analyse.

This book covers the Global Anti-Base Erosion (GloBE) proposal, also known as the Pillar Two proposal. We chose this subject for several reasons. Beyond the merits of the subject matter, the GloBE proposal touches other pertinent issues of our time. These include the issue of sovereignty among nations, the growing influence of the OECD in shaping not only tax treaty policy, but also domestic tax law policy and the increasingly untenable policy conflicts between the interests of developed nations and those of developing nations. All of these themes and more are neatly encapsulated in the GloBE story.

This book is divided into two parts. Part 1 sets out the technical landscape of the GloBE proposal. As the entire proposal hinges on the necessity of a minimum effective tax rate, it is there that the story must begin. We therefore begin by explaining the significance of the minimum effective tax rate and then, using that as a take-off point, set out the other building blocks of the proposal, namely the GloBE tax base, the four GloBE rules and the attendant coordination issues.

Laws do not exist in a vacuum, neither from a conceptual nor a practical perspective. Thus, if implemented, GloBE will have to coexist with other extant tax regimes. This is, of course, the case for any new tax regime.

It is a complex enough undertaking to implement a new tax regime in any one country. This is the crux of the matter: designed to apply across *multiple jurisdictions*, GloBE would greatly magnify that complexity. Its very nature calls for the global alignment of (relevant) domestic law provisions across jurisdictions, coupled with large-scale treaty amendments. This is an unprecedented scale of reform.

What might all of this look like in practice? Part 2 of the book addresses this question. It highlights the potential impact of GloBE in certain key areas, namely, tax treaties, transfer pricing, EU law, US tax reform and developing countries. There are also practical implementation issues, which we address as well. We conclude the book with a look at the scope and policy consistency of the GloBE proposal, set against the backdrop of international tax law.

We expect that this book will contribute much to the emerging body of knowledge on GloBE. Our in-house team of writers and editors have done justice to a labyrinthine and vast new area of taxation. For every single chapter, we have called upon our specialists in the relevant subject areas (e.g. tax treaties, EU law and transfer pricing) and in the relevant jurisdictions. As regards the latter, we have also highlighted those regions that bring up particular issues for GloBE (e.g. developing countries, the European Union and the United States).

As the GloBE proposal winds its way forward, we may expect further debate and change, and, as good stewards of international taxation, IBFD will continue to monitor, report and analyse.

Even so, what we offer today is the GloBE proposal, set in deep context from every possible angle: principle, policy and practice.

We trust you will find this of much value.

Belema R. Obuoforibo CTA ATT (Fellow)
Director, IBFD Knowledge Centre
11 December 2020

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Part 2
The Broader Policy and Legal Framework

Introduction

The cornerstone of the BEPS Project, BEPS Action 1, was concerned with introducing measures adequate to realign international taxation with a way of conducting business very different from that in place when the bases of the existing international tax regime were established back in the 1920s. Yet the final report did not provide immediate solutions but paved the way for further work.

After a process of trial and error, including public consultations with major stakeholders in an attempt to achieve a balancing of all the key perspectives involved, it seems that about a century after the reaching of the so-called 20s compromise that shaped international tax rules, a new framework for a 2020 compromise may be ready, if not to be immediately adopted, at least to be carefully considered. The Blueprints for the so-called Pillar One and Pillar Two – as envisaged by the 2019 Programme of Work of the OECD Secretariat and delivered by the Inclusive Framework in October 2020 – constitute the basis on which such new compromise may be built.

The common denominator of the current Blueprints can be found in the acknowledgement that an intervention merely targeted on fixing the existing rules in light of new digitalized business models would not be sufficient and, instead, a bold new framework for reform needs to be adopted. Explicitly or implicitly, such a revised framework is meant to impact the relations between “residence” and “source”. Traditionally, over the last century and, in particular, over the last 10 years, all tensions surrounding the relations between these two poles have been meant to be addressed by intervening in what ties them together, namely rules surrounding the attribution of profits. This more traditional line of work has been entrusted, within the current package of proposals, to the Pillar One measures.

It is, however, Pillar Two that entails what may constitute the greatest shift in the international tax regime since its inception. As per the 2019 OECD Secretariat Programme of Work, Pillar Two is meant to focus on the “remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to ‘tax back’ where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation”. As this statement of purpose implies, this residual and protean target may only be addressed by focusing not only on “profit attribution” or on “distributive rules” but on actual “taxing rules”, by balancing out mismatches between systems and substantially foreseeing that income should be taxed at least once at a minimum tax rate to be determined in light of a global consensus yet to be achieved at the time of writing.

Such a momentous shift, which will profoundly reshape the "object and purpose" of international tax rules, inevitably requires a complex rewiring of the international treaty network, as well as an intervention on the way domestic rules interact with each other in connection with cross-border transactions. Despite the high complexity of this mechanism, the way the proposals have been formulated is quite schematic and efficient, relying on three main rules meant to create a Global Anti-Base Erosion (GloBE) framework, which in their fundamental structure do not appear to be unheard of, as examples thereof can be found in several domestic experiences and treaty networks. These are (i) an "income inclusion rule" and (ii) a "switch-over rule", on the domestic and treaty planes, respectively, to be enforced by residence countries; and (iii) an "undertaxed payments rule", to be put in place by source countries, with the latter countries also being prompted to incorporate in their treaty networks a re-elaboration of the familiar "subject-to-tax rule", which, while not part of the GloBE rules *stricto sensu* (as outlined in the Blueprint), would be counted in the same package.

While the pieces of this complex puzzle may not look completely alien, their complex interaction and the fact that they would be meant to be adopted on a global level represent a novel challenge deserving the in-depth scrutiny that only a comprehensive volume can achieve. In light of such considerations, this book humbly means to address all of the above-mentioned rules in a systematic and comprehensive way, based on the essential specifications that were disclosed in the October 2020 Pillar Two Blueprint Report.

Part 1 addresses the "Design and Technical Aspects of the Proposed Rules". In light of the driving role played by the emerging perceived need for a global effective minimum tax rate and the interconnected need for fostering a global tax base, the introductory chapters in this part of the book deal precisely with these two concepts, acknowledging that, especially when it comes to the determination of the rate (chapter 1), the main issue will be no less a political issue than a technical one. With regard to the design of a global tax base (chapter 2), although the exercise is unprecedented when it comes to fostering international harmonization in that regard, similar experiences (or at least attempts) can be observed in regional projects, so that an analysis of these experiences (or attempts) may provide some food for thought for the whole Pillar Two exercise.

The remainder of part 1 is devoted to a technical analysis of each of the four rules that constitute the Pillar Two proposal, namely the income inclusion rule (chapter 3), the switch-over rule (chapter 4), the undertaxed payments rule (chapter 5) and the subject-to-tax rule (chapter 6). The complex interplay between the rules is then addressed in chapter 7, which concludes part 1. All these chapters not only attempt to conduct a close examination of the mechanics of the proposed rules, which is supported by ample use of numerical examples, but also try to place the rules in the broader policy framework and, where appropriate, recall earlier domestic experiences that, although concerned with a much less ambitious scale, may highlight possible hurdles associated with the proposed Pillar Two rules, as well as possible solutions for their implementation.

Part 2, on the other hand, is meant to approach the proposed rules dynamically, setting them against the backdrop of relevant pre-existing legal and policy frameworks. In particular, chapter 8 addresses the interaction between the proposed Pillar Two rules and tax treaties, and chapter 9 is concerned with the interface with one of the pillars of the existing international tax regime and, most notably, with the arm's length standard. In doing so, the analysis is, however, not only conducted on a purely abstract legal and policy plane, but specific practical hurdles are also thereby addressed, such as the relevance of the country-by-country reporting experience for the implementation of the Pillar Two rules.

Part 2 then proceeds by addressing the interaction between the proposed Pillar Two rules and selected regional and national legal frameworks. Most notably, chapter 10 is concerned with the interaction with EU law, in particular EU primary law, and attempts to provide inputs on how possible frictions may be reconciled. Chapter 11 moves across the Atlantic to focus on the interplay between US international tax rules, as shaped by the last tax reform, and the proposed Pillar Two rules. This chapter analyses measures adopted by the United States that may to some extent be seen as a source of inspiration for the building blocks of the Pillar Two proposal, notably the GILTI rules and the BEAT. Chapter 12 is meant to contribute a truly global and developmental perspective to this volume, focusing in a constructively critical way on the hurdles that the whole international tax reform process, as well as the implementation of the proposed Pillar Two rules, may present to the developing and emerging worlds. In this regard, the chapter adopts a distinctly regionally differentiated perspective, focusing in turn on the Africa-Middle East, Asia-Pacific and Latin American regions, and relies upon inputs collected by IBFD regional specialists via a targeted survey.

The remainder of part 2 is then devoted to addressing what may lie ahead in terms of possible means of implementation of the Pillar Two proposal and the remaining policy hurdles to be appreciated when considering that the proposal cannot be understood in isolation or as a means to an end but, rather, must be seen as a new and crucial tile in a very complex mosaic that brings together the broader work on the taxation of the digitalized economy pursued under Pillar One (chapter 13), along with the distinct yet complementary work that has so far been carried out in connection with the prevention of abuse at the international and regional levels (chapter 14).

In light of all the above, the editors sincerely hope this book will stimulate further discussion and be of use to practitioners, students and policymakers, trying as it does to bring together the two complementary needs of ensuring the most up-to-date and topical coverage of this momentous turning point in international taxation with the necessary depth of analysis and the "big picture" view that should always inspire any research pursuit.

Andreas Perdelwitz and Alessandro Turina
Managing Editors
10 December 2020

Chapter 8

Interaction of Pillar Two with Tax Treaties

Betty Andrade Rodríguez and Luis Nouel*

8.1. Setting the scene

Pillar Two represents a significant departure from traditional tax rules, as it has been conceived with BEPS in mind, instead of following the more traditional principles that have been shaping public finances for decades. In contrast, tax treaties have been conceived as instruments that would help in preventing double taxation, a pernicious byproduct of the application of traditional tax rules.

The purpose of this section is to foresee how the proposed Pillar Two rules would interact with established tax treaty practice which, after so many years, still retains some ambiguities. Potentially, an interesting mix for the curious and the daring.

As the analysis must start somewhere, perhaps it would be a good idea to start with the most basic question of all: are the Pillar Two rules covered by tax treaties?

The question of whether the proposed taxes under the Pillar Two rules are covered by existing income tax treaties was not examined thoroughly in the discussion draft, but rather was quickly assumed to be a *fait accompli*. For this reason, the Pillar Two rules will be tested separately, starting with the treaty entitlement of the income inclusion rule (IIR) and the undertaxed payment rule (UTPR). Also, other potential conflicts must be analysed, especially considering the parallelism of the IIR with controlled foreign corporation (CFC) rules and whether the UTPR could be considered discriminatory under tax treaties.

Further, the subject-to-tax-rule proposed as a tax treaty provision will be analysed in its context, especially looking at potential conflicts with

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articles 7, 11 and 12 of the OECD Model[1] and with the tax sparing clauses contained in some treaties.

Finally, we will take a look at some of the implementation aspects of Pillar Two in relation to tax treaties and from this perspective, provide some thoughts on how these rules could be implemented.

8.2. Income inclusion rule

The IIR requires that a parent entity recognize as income the proportionate share of income of each of its constituent entities in a similar fashion as CFC rules impute income from the profits of a CFC. Such income is then taxed in the parent entity's hands with a top-up tax that is calculated on the excess of the minimum effective tax rate (ETR) over the ETR as calculated for that jurisdiction in the relevant period.[2] In a nutshell, it works as a minimum tax on income. But is it covered by tax treaties?

As the taxable base for Pillar Two is based on the income of the subsidiaries, it fits effortlessly within article 2(2) of the OECD Model,[3] as the article indicates that a treaty that follows the OECD Model will be applicable to taxes on total income and on elements of income.

In practice, however, the issue may be more complex than it seems. There are many treaties that do not include the wording of paragraph 2 of the OECD Model: for instance, Brazil would typically not include article 2(2) in their tax treaties.[4] The same applies to some treaties concluded by Australia, India, United Kingdom, United States, etc., which makes the assumption made by the OECD more complex, as in the absence of the this "abstract" rule, the substantive scope of article 2(3) would be less enunciative and more restrictive. Ordinarily, the list of applicable taxes in article 2(3) would have been merely enunciative of the taxes that were in force at the time of

1. Our analysis is based on treaties following the OECD Model Tax Convention. For consistency's sake, we will use such model as a template unless otherwise indicated. All assumptions or statements made in connection with the OECD Model are equally valid for the UN Model, except as otherwise provided.
2. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS* para. 681 (OECD 2020) [hereinafter *Pillar Two Blueprint*].
3. *OECD Model Tax Convention on Income and Capital* art. 2 (21 Nov. 2017), Treaties and Models IBFD.
4. Brazil has made clear in the Non-OECD Economies' Positions on the OECD Model that it reserves the right not to include paragraph 2.

the negotiation of the treaty, as is generally considered by the doctrine,[5] some jurisprudence[6] and by the OECD itself.

In these cases, it could be argued that the IIR would be dealt with by article 2(4). This article indicates that taxes imposed after the signing of the treaty will be covered if they are *identical or substantially similar* to the taxes on income and capital listed in article 2(3). The model also requires that the new tax is imposed *in addition to* or *in place of* the listed taxes.

The IIR would be imposed in addition to the taxes on income included in the list of article 2(3); the question is whether they are of an identical or similar nature. The model does not define the terms *identical* or *substantially similar*, so their interpretation would be based on domestic law, as required by article 3(2) of the OECD Model. In the absence of such definition, they must be interpreted according to the ordinary meaning of the terms as prescribed in the Vienna Convention on the Law of Treaties. Alternatively, some countries may try an autonomous definition. In this regard, Vogel[7] distinguishes between two different approaches: a micro approach, in which a comparison of the fundamental elements of both taxes are compared; and a macro approach, in which the comparison requires an assessment of the tax system as a whole. In practice, this comparison would have to be made on a case-by-case basis and different outcomes are a real possibility.

An issue that is still unresolved and impacts the treaty entitlement for the IIR is whether taxes applied to fictitious income are covered by tax treaties. As the IIR computation relies on income that does not belong to the taxpayer but to its constituent entities, it does not create an increase in wealth to the taxpayer, so might therefore be considered a tax on fictitious income.

Brandstetter[8] notes that treaties use words such as “derived”, “paid”, “payments”, “profits” and “gains” in a consistent manner in many of the distribu-

5. *See* P. Brandstetter, *Taxes Covered*, Books IBFD (accessed 3 Nov. 2020). In chapter 2.3, the author refers to the discussions of the original drafters from article 2(2). Nonetheless, Vogel refers to the clause in 2(3) as a deeming provision with amplifying power that may list taxes that are not taxes on income or capital contradicting the enunciative character of the norm. *See* K. Vogel, *Klaus Vogel on Double Taxation Conventions* p. 26 (CCH 2006).
6. In the Ultramarine case, the French *Conseil d’État* considered that the *cotisation foncière des entreprises* was not enumerated in article 2 of the New Caledonia-France tax treaty and that the treaty was therefore not applicable. However, the same court decided a year later in the Deutsche Bahn AG case that the French railway tax was not covered by the France-Germany treaty due to the nature of the tax.
7. K. Vogel, *Klaus Vogel on Double Taxation Conventions* p. 27 (CCH 2006).
8. P. Brandstetter, *“Taxes Covered”* sec. 3.2.1.3.2. (IBFD 2010), Books IBFD.

tive rules, which would seem to indicate that, based on the ordinary meaning of these words, an increase in wealth is implied. However, the author also indicates that there is disagreement in the doctrine, even if the commentaries often refer to the use of a broad interpretation of those terms.

As a closing remark, there might be different outcomes to the issue of treaty entitlement; to avoid ambiguous interpretations, the income inclusion rule should be expressly included as a tax on income in the text of treaties, either by renegotiation or by including it in a multilateral treaty that would apply as *lex specialis* to existing tax treaties.

8.2.1. Saving clause

The Pillar Two Blueprint states that tax treaties should not create an obstacle to the implementation of the income inclusion rule and the UTPR.[9] This assumption relies on the idea that tax treaties are not intended to restrict a jurisdiction's right to tax its own residents. This concept, which is referred to as the "saving clause", is included in article 11(1) of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)[10] and in article 1(3) of the OECD Model Convention of 2017. The version in the OECD Model Convention reads as follows:

> This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

It is interesting that in the Pillar Two Blueprint,[11] the OECD refers to the savings clause as a "principle", and as such, considers it anointed as a universally accepted and fundamental truth, against which any other outcome is simply an impossibility.

The most widely used international tax treaty practice on the allocation of taxing rights between residence and source countries was pretty much established by the work of the League of Nations in the 1920s.[12] The common

9. *Pillar Two Blueprint*, *supra* n. 2, at para. 679.
10. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties and Models IBFD [hereinafter *Multilateral Instrument*].
11. *Pillar Two Blueprint*, *supra* n. 2, at para. 679.
12. B.J. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12 (2019), Journal Articles & Papers IBFD.

practice is that the jurisdiction in which the income arises, i.e. the source country, has the right to tax, and the country in which a taxpayer is resident also has the right to tax, provided a world-wide tax is applied, as dictated under the country's domestic laws. Treaties were later conceived as a means of preventing double taxation arising from the interaction between source and residence taxation.

Tax treaties operate mainly by restricting the taxing rights of source countries while almost maintaining the taxing rights of resident countries intact. However, this is not a universal truth. There are exceptions included in certain model conventions, such as the case of article 19 and the different provisions included during bilateral negotiations that grant exclusive taxation rights to the source country.

Why did the OECD include the saving clause? The OECD's report on BEPS Action 6[13] introduced the saving clause as part of its discussion about the interaction between CFC rules and tax treaties. While there have been interpretations indicating that CFC rules are incompatible with tax treaties, the OECD report on BEPS Action 6 disagreed with this position, based on a similar position incorporated in the commentaries to the OECD Model that were included in 2010 (6.1 of the Commentary on Article 1(included in the year 2000 and later removed in 2017) and paragraphs 23 (now paragraph 81 and included in the Model in 2010) and 14 of the Commentary on Article 1 and Article 7 (included in 2010 and amended in 2017). Nonetheless, the origin of this discussion is much older, as the authors will show in their discussion of the compatibility of CFC rules with tax treaties.

To prevent this interpretation, the BEPS Action 6 report, inspired by the savings clause used in US tax treaties for a long time, proposed the inclusion of a rule that would indicate that treaties cannot limit the state of residence's right to tax its own resident taxpayers.

Needless to say, the saving clause should not be considered a universal principle, given that there are exceptions, including articles 9(1), 19, 20, 23 [A] [B], 24, 25 and 28. Some OECD member countries even made a reservation on article 1(3) of the new model, while in the MLI a large number of countries decided not to apply the saving clause.

13. OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report* (OECD 2015), Primary Sources IBFD.

8.2.2. Parallelism of the income inclusion rule with CFC rules

The IIR requires that a parent entity recognize as income the proportionate share of income of each of its constituent entities located in low-tax jurisdictions. Such income is taxed in the parent entity's hands up to the Pillar Two minimum rate. The Pillar Two Blueprint notes a parallelism in how the IIR and CFC rules operate, hence, as is mentioned in the Pillar Two Blueprint,[14] it triggers similar questions on the treatment on Pillar Two under tax treaties.

The issue of the compatibility of CFC rules with tax treaties is an old one: in the 1986 Base Companies Report,[15] the OECD was already indicating that it is desirable for CFC measures to comply with the spirit of tax treaties, but recognized that a minority of countries considered such measures as incompatible with treaties because:

– CFC income is taxed in the shareholder's state even if there is no permanent establishment (PE) in the CFC country; and
– the aim of treaties is to prevent double taxation and CFC legislation leads to double taxation.

The ideas discussed in the report were later included in the Commentary to Articles 1 and 10 of the 1992[16] OECD Model Tax Convention.

In 2003, a new wording was included in the commentaries indicating that treaties would not prevent the application of domestic anti-abuse provisions such as CFC rules. That clarification came as an answer to an interpretation whereby articles 7(1) and 10(5) would prevent the application of CFC rules. The statement contained in the Commentary to paragraph 1 was subject to the following two limitations regarding CFC rules:

– they should not be applied to CFCs subject to tax rates comparable to the rates in the shareholder's country of residence; and
– they should not apply to active income.

In the 2003[17] Commentary to Article 7(1), the OECD simply confirmed that the article does not limit the right of a contracting state to tax its own residents under its CFC rules, even though such tax is computed by including

14. *See Pillar Two Blueprint*, *supra* n. 2, at para. 681.
15. OECD, *Double Taxation Conventions and the Use of Base Companies* (27 Nov. 1986), Primary Sources IBFD.
16. *OECD Model Tax Convention on Income and Capital* (1 Sept. 1992), Treaties and Models IBFD.
17. *OECD Model Tax Convention on Income and Capital* (28 Jan. 2003), Treaties and Models IBFD.

the profits of an enterprise of the other contracting state. The commentary further indicated that the tax generated by the CFC rules is levied by a country on its own residents and does not reduce the profits of the CFC entity located elsewhere. According to the OECD, as the profits of the CFC are not reduced, it cannot be said that a tax has been levied on such profits.

Regarding article 10(5), the 2003 Commentary just indicates that this article would not prevent taxation that occurs in the country in which the shareholder of the CFC is resident, as paragraph 5 is aimed at preventing the source state from taxing dividends distributed by non-resident entities.

The limitations contained in the 2003 Commentary to Article 7(1) were subsequently deleted, the first in the 2010 OECD Model and the second in the 2017 Commentary, as the inclusion of the saving clause made the wording redundant.

In practice, the arguments discussed in the commentaries back in 2003 were not as universally accepted as they were made out to be. A number of countries such as Belgium, Ireland, Luxembourg, Netherlands, Portugal and Switzerland had already made clear their disagreement with the main position in the observations to the Commentary to Article 1 of the OECD Model (2003). Also, the fact that in 2017 the OECD included the savings clause in the model shows that the issue of the interaction of CFC rules and treaties was not really settled.

We cannot ignore that there has been case law dissenting from the position held in the commentaries:[18] for instance, in 2002, the French *Conseil de'État*[19] decided in the Schneider case that article 209B of the French tax code cannot apply to a French company with a subsidiary in Switzerland (subject to low taxation and engaged in managing financial assets), as France could not tax the income of the subsidiary unless it carried on business in France through a PE.

In the analysis made by the court, the income of the subsidiary attributed to the French shareholder was characterized as business income (and not a deemed dividend distribution), so that article 7(1) of the 1966 treaty would apply, requiring the Swiss subsidiary to have a permanent establishment in

18. For a complete overview of case law related to the interaction of CFC rules and tax treaties, *see* V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special references to BEPS project)* ch. 18 (R. Danon ed., Schulthess 2018).
19. FR: *Conseil d'Etat* (CE), 28 June 2002, *Société Schneider Electric*, CE Ass., 232276.

France in order to allow France to tax such income. In the absence of such a PE in France, the treaty prevented the application of the tax code.[20]

There have been many other cases that were decided differently, but the lesson from the Schneider case is that not all CFC rules are created equally and the interaction between treaties and CFC rules is not something that can be solved just by amending the commentaries.

The main purpose of CFC rules is to eliminate the deferral of taxes by eliminating the postponement of the taxation of foreign income that has been accrued through the taxpayer's ownership interest in a foreign entity.[21] These rules help to defend national tax bases against base erosion and profit shifting. They do this by imputing deemed dividends or by setting aside the fiction of the legally separate personality of corporate entities and imputing to the shareholder notional income from the CFC.

To the extent that the imputation of income is connected to the profits of a CFC, there will be a tension between the more formalistic interpretation of the OECD, in which the resident state is not really taxing the profits of the CFC as they are not affected, and the more economic approach, in which to avoid the deferral of taxes, the resident state taxes the profits of the CFC (albeit in the hands of the shareholder) and thus creates a conflict with article 7. The authors think that the OECD took the right decision in 2017 by including the saving clause in the Model and in the MLI, sheltering the legitimate need of states to protect their tax bases.

If this is translated to the IIR, by accepting the parallelism with CFC rules, it must be concluded that unless the particular treaty includes a saving clause (either as a product of bilateral negotiations or by means of the application of the MLI to a covered bilateral tax treaty), there might be the possibility of challenging the IIR. For this reason, the authors believe that for the sake of providing certainty, countries implementing the IIR should try to incorporate a savings clause in their tax treaties.

20. In 2005, the French CFC rules changed to make them compatible with tax treaties; *see* C. Garcia, *Chapter 16: Controlled Foreign Company Legislation in France*, in *Controlled Foreign Company Legislation* (G.W. Kofler et al. eds., IBFD 2020), Books IBFD.

21. For more on CFC rules, *see* B.J. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12 (2019), Journal Articles & Papers IBFD (accessed 12 Nov. 2020).

8.3. Undertaxed payment rule

The UTPR requires a UTPR taxpayer that makes deductible payments to constituent entities located in low-tax jurisdictions to make an adjustment in respect of any top-up tax that is allocated to that taxpayer. The rationale behind the rule is to neutralize any base erosion produced by payments made to low-tax jurisdictions.[22]

The top-up tax is allocated via a two-step approach. The first step applies when the UTPR taxpayer makes any deductible payments to the low-tax entity and the tax is allocated in proportion to the deductible payments made to such low-tax entity by all UTPR taxpayers during the relevant period. In the second step, if the UTPR taxpayer has net intra-group expenditure, the remaining top-up tax is allocated in proportion to the total amount of net intra-group expenditure incurred by all UTPR taxpayers.[23]

However, the UTPR only applies in cases of the income of a low-tax constituent entity not being taking into consideration for the IIR applied to the taxpayer in accordance with the Pillar Two rules.[24]

The Blueprint indicates that the Pillar Two rules do not establish the mechanism by which this adjustment to the top-up tax must be made. This is left to the domestic law of countries that decide to adopt the UTPR. The adjustment may be implemented in domestic law as a limitation or a denial of the deduction for payments made to related parties or may be implemented in the form of an additional tax.[25]

8.3.1. Associated enterprises

The denial of a deduction under the UTPR could result in a higher taxable base than the base based on arm's length profits. It is for this reason that the Blueprint on Pillar Two discusses whether the denial could conflict with article 9(1) (Associated Enterprises) of the OECD Model or, where the UTPR applies to a PE, article 7(2). It mentions that it is generally recognized that once the profits have been allocated in accordance with the arm's length

22. *Pillar Two Blueprint*, *supra* n. 2, at para. 457.
23. Id., at para. 473.
24. Id., at para. 459.
25. Id., at para. 519.

principle, how they are taxed is a matter determined by the domestic law of each country.[26]

Article 9 simply allows a contracting state to make adjustments to transactions between associated parties when such transactions are not in accordance with the arm's length principle and tax accordingly. This cannot be done independently and how it is done is an issue of domestic law.[27] The question is whether the article would prevent the UTPR from denying or limiting a deduction or whether it would prevent the application of a top-up tax. Regarding the first scenario, transfer pricing rules are limited on the determination of the remuneration for a specific transaction and to some extent the nature of it. Whether a transaction is deductible or not is an issue of domestic law even in cases where transfer pricing rules are able to recharacterize the nature of the transaction. Countries implementing a UTPR need to harmonize any potential conflict between the transfer pricing rules and the domestic rules implementing a UTPR.

Regarding article 7, the Blueprint follows the same line of thought based on "the longstanding principle" of the saving clause (*see* section 8.2.1.) and in paragraph 30 of the Commentary to Article 7 of the OECD Model. Regarding the saving clause, it was already discussed in section 8.2.1. that it is not a long-standing principle and that the current Commentaries reproduce the 2010 OECD Model article on business profits, which has been incorporated in a minority of existing treaties. Although the OECD included a similar wording in 2008 when it concluded the authorized approach to attributing profits to permanent establishments, it is questionable whether those commentaries can be used for treaties concluded previous to this particular model.[28]

8.3.2. Non-discrimination

The Blueprint also considered the compatibility of the UTPR with article 24 of the OECD Model,[29] namely article 24(4), which requires equal treat-

26. Id., at para. 689.
27. K. Vogel, *On Double Tax Conventions* p. 521 (Kluwer Law 1997).
28. It should be noted that when the OECD included the authorized approach in the 2008 Model, it was indicated that in designing it, the Committee of Fiscal Affairs was not constrained by either the original intent or by the historical practice and interpretation of article 7 of the OECD Model. For this reason, the dynamic use of the new additions to the commentaries to already existing tax treaties should not apply, as the additions went beyond a simple clarification.
29. *See Pillar Two Blueprint*, *supra* n. 2, at para. 690-696.

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