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Effective Tax Rate Criteria and Source Taxation under the OECD's Pillar Two Proposals

This article aims to analyse how the effective tax rate criteria of the OECD's Inclusive Framework Pillar Two proposal affects source taxation, particularly with regard to its effects on developing countries as Source Countries.

1. Introduction

Pillar Two, the OECD's proposal for a minimum level of taxation for multinational companies (MNCs) that rules out possible advantages arising from favoured taxation, has been presented as having a wider scope than the Actions of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project themselves.[1] It consists of the Global Anti-Base Erosion (GloBE) proposals (i.e. the Income Inclusive Rule (IIR) and the Undertaxed Payment Rule (UTPR)), which depend on the calculation of an effective tax rate (ETR) of less than 15% to be assessed on a jurisdictional approach. Consequently, the ETR criteria may have gained in complexity with the issuing of the Pillar Two Model Rules[2] and the Commentary to the Pillar Two Model Rules.[3]

This article is intended not to be a mere additional contribution in international taxation literature endorsing how Pillar Two harms source taxation in general but, rather, to analyse in depth (i) particular provisions set out by the GloBE Model Rules; and to scrutinize (ii) the specific effects on tax sparing and matching clauses; and also (iii) withholding taxation on cross-border payments, as all these three mechanisms are broadly adopted by typical Source Countries.[4]

Accordingly, after defining relevant aspects of source taxation (*see* section 2.), this article examines, in section 3., how the ETR criteria restrict source taxation (not only through the ordering rules of the UTPR, the IIR and the Qualified IIR, but also through the specific role of the qualified domestic minimum top-up tax (QDMTT) and the calculation of the ETR regardless of withholding tax). Section 4. evaluates how the ETR neutralizes tax incentives afforded by Source Countries. Accordingly, section 5. addresses specifically how GloBE hinders the application of tax sparing and matching credit clauses. The article's conclusions are presented in section 6.

2. How Far May Source Taxation Be Restricted by Pillar Two?

Before arguing how Pillar Two harms source taxation, it is important to define which aspects of source taxation are at stake. It would be frivolous and too broad to state that source taxation, in general, is inhibited by Pillar Two proposal.

As stated by Arnold (2019), the ordering of the imposition of income taxation by Residence Countries and Source Countries would be relatively straightforward. In other words, when both impose tax on income, the Source Country would be considered to have priority.[5] This general principle is said to rely not only on source taxation itself, but also on the alleged obligation of the Residence Country to relieve double taxation by exempting foreign-source income from the Residence Country tax on it or allowing a credit against it.[6]

On the basis of these assumptions, three aspects of source taxation were selected to be addressed in this article. These are:

(1) source taxation through income withholding tax;
(2) the recognition of the possible renunciation of the Source Country's power to tax (i.e. granting tax incentives) as an immanent part of that power within the framework of the state sovereignty;[7] and
(3) as consequence of the latter, the role of tax sparing clauses as a tool to preserve tax incentives and, therefore, the Source Country's sovereignty.

With regard to the first of these aspects, its importance is quite unequivocal. Developing countries have historically

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1. P. Pistone et al., *The OECD Public Consultation Document "Global Anti-Base Erosion (GloBE) Proposal – Pillar Two": An Assessment*, 74 Bull. Intl. Taxn. 2, sec. 1.2. (2020), Journal Articles & Opinion Pieces IBFD; J. Englisch & J. (Johannes) Becker, *International Effective Minimum Taxation – The GLOBE Proposal*, 11 World Tax J. 4, sec. 2.2.3. (2019), Journal Articles & Opinion Pieces IBFD; and C. Cipollini, *GloBE Proposal and Possible Carve-Outs: Is There a Future for Preferential Tax Regimes?*, 12 World Tax J. 2, sec. 2.1. (2020), Journal Articles & Opinion Pieces IBFD.
2. *See* OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2021), Primary Sources IBFD [hereinafter the *Pillar Two Model Rules*].
3. *See* OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2022), Primary Sources IBFD [hereinafter the *Commentary to the Pillar Two Model Rules*].
4. A.W. Oguttu, *A Critique from a Developing Country Perspective of the Proposals to Tax the Digital Economy*, 12 World Tax J. 4, sec. 7.1. (2020), Journal Articles & Opinion Pieces IBFD.
5. B.J. Arnold, *International Tax Primer* 4th edn., p. 34 (Kluwer L. Intl. 2019).
6. B.J. Arnold, *The Ordering of Residence and Source Country Taxes and the OECD Pillar Two Global Minimum Tax*, 76 Bull. Intl. Taxn. 5 (2022), Journal Articles & Opinion Pieces IBFD.
7. A. Gutierrez, *La soberanía fiscal, la potestade tributaria y los convênios para evitar la doble imposicion* Cont4bl3 50, p. 1 (AECE 2014).

relied on source taxation to protect their tax bases and in light of its ease of administration.[8]

Withholding taxes have even been recommended in literature to tax digital economy[9] and a number of Latin America countries still follow this paradigm. In Brazil, for example, all cross-border payment for services and intangibles is taxed at source. In Peru, gross income derived by a non-resident must be apportioned by means of a deemed source rule when services are perfumed partly inside and partly outside the country.[10] In Uruguay, on the other hand, since 2018, services provided digitally are considered to be 100% sourced in the country if the supplier and the user are situated there and 50% Uruguay sourced if one or the other is outside the country.[11] In Asia, Taiwan has established a 20% income withholding tax on services provided by a non-resident with no fixed place of business in the country.[12] In Africa, Zimbabwe has amended its Income Tax Act[13] to provide that any amount receivable by or on behalf of an electronic (e-)commerce platform domiciled outside Zimbabwe from residents of that country should be subject to income withholding tax.[14] In South Africa, the Davis Tax Committee has recommended that tax rules in the country should be based on the payer principle, so that income withholding tax would be levied on payments remitted abroad.[15] In light of the foregoing, it may be asked how withholding taxation is still alive and crucial for source taxation (specially in developing countries that rely on this kind of tax as a backstop for excessive base-eroding payments remitted abroad).[16]

Tax incentives, on the other hand, are still considered to be an important tool of fiscal policy of Source Countries, despite the dispute about the efficiency of this measure. Some authors argue that tax incentives do not necessarily enhance foreign direct investment (FDI),[17] others state that tax incentives granted by developing countries are not based on cost and/or benefit analysis, but due to the threat of multinational enterprises (MNEs) going elsewhere.[18] The OECD goes even further, and suggests that developing countries are subject to abuse by MNCs and harmful tax competition so that these countries are forced to provide undue tax incentives that undermine their tax revenue.[19] Tax incentives, however, have historically been adopted by developed countries, but they appear to be odious once developing countries benefit from them as well.[20]

Very similar criticism is also directed towards tax sparing clauses. The effects of a sole enactment of domestic tax incentives without combining them with an international rule protecting the effectives on this tax incentive would be annulled if the Residence Country were not to be prevented from taxing this exact portion.[21] Accordingly, tax sparing clauses are defined not only as an exemption tax incentive rule, but rather as a tool to guarantee the effective implementation of domestic tax incentives.[22]

The OECD followed this line of reasoning in the Commentary on Article 23 of the OECD Draft (1963).[23] Subsequently, the Commentary on Article 23 of the OECD Model (2000)[24] revealed the change of position on such clauses by advising limiting their use, recasting the results of the 1998 OECD Report "Tax Sparing: A Reconsideration",[25] which has been criticized previously.[26]

Despite all possible uncertainties about the effect of tax sparing clauses as a means to attract foreign investments, tax treaties should still include clauses that prevent Residence Countries to deprive Source Countries of their own tax policy decisions or let the latter to have their share of revenue from income sourced within their territory.[27]

Still, tax sparing clauses – despite all the disputes about their virtues – are relevant in international taxation, as from the approximately 4,000 tax treaties signed between 1 January 2000 and 16 February 2020, more than 100

8. Oguttu, *supra* n. 4.
9. A.B. Moreno & Y. Brauner, *Withholding Taxes in Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy*, WU International Taxation Research Paper Series, No. 14, p. 12 (2015).
10. B.J. Arnold, *The Taxation of Income from Services*, UN Paper 2 – Papers on Selected Topics in Protecting the Tax Base of Developing Countries, p. 14 (UN 2013).
11. ORBITAX, *Uruguay's New Source Rules and Tax Obligations for Digital Services*, available at www.orbitax.com/news/archive.php/Uruguay-New-Source-Rules-and-32367 (accessed9 July 2023).
12. KPMG, *Taxation of Digitalised Economy*, p. 17 (2018) and Deloitte, *New Rules on Taiwan Source Income derived by Non-resident Suppliers of E-services* (Mar. 2018), available at www.taxathand.com/article/8988/Taiwan/2018/New-rules-on-Taiwan-source-income-derived-by-non resident-suppliers-of-e-services (accessed 9 July 2023).
13. ZW: Income Tax Act, ch. 23:06.
14. Oguttu, *supra* n. 4.
15. ZA: Davis Tax Committee, *Report on Action 1: Address The Tax Challenges of the Digital Economy* p. 4 (2016).
16. M. Graetz, *The David Tillinghast Lecture, Taxing International Income – Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261, p. 281 (2001).
17. A.W. Oguttu, *International Tax Competition, Harmful Tax Practices and the 'Race to the Bottom': A Special Focus on Un-strategic Tax Incentives in Africa, The Comparative and International Law*, 3 J. S. Afr., pp. 293-319 (2018).
18. R.S. Avi-Yonah & Y.R. (Christine) Kim, *Tax Harmony: The Promise and Pitfalls of the Global Minimum Tax*, 43 Mich. J. Intl. L., p. 41 (May 2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4102332 (accessed 20 Mar. 2023).
19. OECD, *Programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy* para. 50 (OECD 2019).
20. M. Herzfeld, *News Analysis: Political Reality Catches Up With BEPS*, Tax Analysts p. 2 (3 Feb. 2014).
21. B. Andrade Rodríguez, *A Look at Tax Sparing Clauses in the 21st Century as Tools for the Implementation of Tax Incentives from the Perspective of Developing Countries*, 3 Intl. Tax Stud. 7, sec. 1. (2020), Journal Articles & Opinion Pieces IBFD; and C. Peters, *On the Legitimacy of International Tax Law* pp. 9-10 (IBFD 2014), Books IBFD,.
22. Andrade Rodríguez, *supra* n. 21.
23. *OECD Draft Tax Convention on Income and on Capital: Commentary on Article 23(A) and 23(B)*, para. 50 (30 July 1963), Treaties & Models IBFD.
24. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23(A) and 23(B)*, para. 72-78 (29 Apr. 2000), Treaties & Models IBFD.
25. OECD, *Tax Sparing: A Reconsideration* (OECD 1998), available at https://doi.org/10.1787/9789264162433-en (accessed 9 July 2023).
26. L.E. Schoueri, *Tax Sparing: A Reconsideration of the Reconsideration, Tax, Law and Development* (Edward Elgar 2013).
27. Andrade Rodríguez, *supra* n. 21, at sec. 3.2. and P. Pistone & T.J. Goodspeed, *Rethinking Tax Jurisdictions and Relief from International Double Taxation in Relation with Developing Countries: Legal and Economic Perspectives from Europe and North America*, in *International Tax Coordination: An Interdisciplinary Perspective on Virtues and Pitfalls* p. 8 (M. Zagler ed., Routledge 2010).

include some form of tax sparing clause – according to a survey carried out by Andrade Rodríguez (2020).[28] Thuronyi (2003) has verified that a third of the tax treaties negotiated between 2000 and 2003 included tax sparing clauses.[29] Andrade Rodríguez has added that, before 2000, a relevant number of tax treaties included this kind of rule.[30]

Following the demonstration that these three aspects are relevant for source taxation, the article now address in sequence how the Pillar Two proposal deals with them. This is the subject matter of sections 3., 4. and 5.

3. How ETR Criteria Harm Source Taxation

3.1. ETR criteria

Given the assumption that Pillar Two empowers jurisdictions to tax income that was not sufficiently taxed by the country that held the so-called "primary tax rights", it is necessary to understand what income should be considered to be taxed that falls below the ETR, and, therefore, what are the parameters that are expected to give rise to the application of the primary IIR rule or the secondary UTPR rule. As revealed in article 5.1.1. of the Pillar Two Model Rules,[31] the OECD suggests that the ETR should to be calculated on a jurisdictional basis – as will be assessed in section 5. – by dividing the sum of the "adjusted covered taxes" of each Constituent Entity (defined under article 1.3 of the Pillar Two Model Rules as any entity or permanent establishment (PE) included in the multinational group to be considered within the scope of GloBE) in a jurisdiction by the "Net GloBE Income", which is defined as the financial accounting net income or loss determined for each considered entity in a specific fiscal year adjusted for some items imposed by the Pillar Two Model Rules.[32] That is, some kind of tax results derived from financial accounting profits adjusted by some amounts that must, or must not, be considered with regard to the GloBE proposals.

First, it is necessary to disclose that the OECD defines "adjusted covered taxes" as:

– taxes recorded in the financial accounting books of a Constituent Entity with regard to its income or profits or income or profits of a Constituent Entity in which it owns control;
– taxes on distributed profits and/or deemed profit distributions;
– taxes imposed in lieu of generally applicable corporate income tax; and
– taxes levied by reference of retained earnings and corporate equity.[33]

Moreover, as previously set out in the paragraph 145 of the Pillar Two Blueprint,[34] adjusted cover tax encompasses taxes paid by the parent company as a result of controlled foreign company (CFC) rules. This situation exposes a contradiction in the – so to speak – conceptual position that the OECD has been adopting about the supposed compatibility between the CFC rules and the equivalent of article 7 of the OECD Model in tax treaties.[35]

This being said, the OECD proposes that the tax paid by the intermediate parent company under the CFC rules should be attributed to the final subsidiary, as if it were a tax borne by the final subsidiary. On the other hand, the OECD has understood – to justify the compatibility of the CFC rules with article 7 of the OECD Model – that these rules affect the profits of the controlling company itself and not of the investee.

The two arguments are contradictory, however. Either the taxed income belongs to the investor (so that the CFC rules do not violate article 7 and the taxes paid as a result of them are attributable to the parent company), or the profits belong to the investee, and, therefore, the CFC rules are incompatible with article 7 and the taxes paid under these rules are attributable to the subsidiary.

3.2. Effects of withholding taxes imposed in Source Countries: UTPR times qualified IIR and QDMMT

In addition to considering the UTPR a secondary measure in relation to the IIR (according to the order rules set out in the GloBE proposals), the Pillar Two Model Rules exacerbate the OECD's preference for Residence Countries over Source Countries in view of two particularities in the ETR criteria. First, according to article 2.5.2. of the Pillar Two Model Rules,[36] a UTPR designed by a Source Country will not be applicable if the Residence Country adopts a qualified IIR, which is defined in article 10.1 of the Pillar Two Model Rules as a set of rules equivalent to the GloBE IIR that are included in the domestic law of a jurisdiction and that are implemented in a consistent way with the outcomes provided by the GloBE Rules[37] and the Commentary to the Pillar Two Model Rules.[38] This means that the UTPR is not only secondary to an IIR, as provided for by a Residence Country, but also to a qualified IIR, and, therefore, the UTPR is twice secondary.

It could be sustained that the issue relating to the ordering rule in the Pillar Two proposal and the secondary application of the UTPR, even in face of a qualified IIR, could be resolved by the provision of a QDMTT, whose application is primary in relation to the GloBE measures. In this context, and just for the sake of clarification, it would be necessary to bear in mind that a QDMTT is defined as minimum top-tax included in the domestic law of a jurisdiction that determines excess profits or increases tax liability with regard to such excess profits to the minimum

28. Andrade Rodríguez, *supra* n. 21, at sec. 4.
29. V. Thuronyi, *Recent Treaty Practice on Tax Sparing*, 29 Tax Notes 3 (Jan. 2003).
30. Andrade Rodríguez, *supra* n. 21, at sec. 4.
31. OECD, *Pillar Two Model Rules*, *supra* n. 2, at p. 28.
32. Id., at p. 15.
33. Id., at p. 23.
34. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project p. 122, para. 456 (OECD 2020), available at https://doi.org/10.1787/abb4c3d1-en (accessed 8 May 2021).
35. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 7*, para. 14. (21 Nov. 2017), Treaties & Models IBFD, also available at https://doi.org/10.1787/mtc_cond-2017-en (accessed 9 July 2023).
36. OECD, *Pillar Two Model Rules*, *supra* n. 2, at p. 14.
37. Id., at p. 65.
38. OECD, *Commentary to the Pillar Two Model Rules*, *supra* n. 3, at p. 212.

rate in accordance with the GloBE proposals.[39] Such a state of affairs means that it is equivalent to an IIR, but applicable by any country (and not only the ultimate parent entity (UPE) jurisdiction).[40]

The QDMTT works as if it were a Source Country's IIR, authorizing the levying of a top-up tax on the excess profits generated by a controlled company of an MNE in the Source Country. This means that the QDMTT could raise the ETR of a company, thereby precluding UPE's jurisdiction from charging any top-up tax under the IIR.[41]

Because of this situation, the QDMTT is considered to be a compensatory measure that enables Source Jurisdictions to collect extra tax revenue[42] or even as a means to move Source Countries to the head of the ordering queue and to impose tax in preference to the Residence Country.[43] The QDMTT would provide Source Countries with an alternative mechanism to raise their ETRs to the 15% minimum rate, thereby avoiding the application of the GloBE measures to Resident Countries,[44] which undoubtably could be an advance for Source Countries.

Nevertheless, it should be noted that the QDMTT may be difficult to be implemented by many jurisdictions, as the domestic corporate tax base must be the same (or broader) as the base for the minimum tax[45] (which should also depend on the withdrawal of many tax incentives – as is addressed in section 4.). Arnold (2022) explains that, under this scenario, the credit of the QDMTT would reduce the Source Country's corporate tax, thereby reducing the amount of "covered taxes" allocated to the Source Country, such that the Source Country's ETR would be less, and, therefore, increasing the jurisdictional top-up tax.[46]

In addition, the GloBE Rules do not envisage any double taxation relief in respect of the QDMTT paid in the Source Country. The issue becomes even worse when countries allow their QDMTT to be credited against their domestic corporate income tax, as, in this case, the QDMTT would be disregarded on the calculation of the ETR, thereby making the Residence Country eligible to charge top-up tax under the IIR.[47]

Moreover, Chand (2022) is correct in stating that countries may disagree in the characterization of their own internal rules.[48] That is, a hypothetical Country A may believe that its internal rule should be held as a Qualified IIR or a QDMTT, which would affect (or even avoid) the top-up taxation measures to be taken in the ultimate parent jurisdiction – Country B, for example. On the other hand, the tax authorities of Country B may disagree with that stance, and charge top-up taxes on the UPE in assuming that no QIIR or QDMTT had been applied on Country A. As the GloBE Rules now stand, no cross-border dispute resolution framework has been provided, and there is reasonable doubt whether the already existing mutual agreement procedure (MAP) envisaged in tax treaties would be sufficient – i.e. one that should deal with issues derived from the interpretation of conventional rules rather than domestic rules.[49]

Lastly, the QDMTT as a top-up tax established in the Source Country's ordinary corporate income tax system does not settle the issue regarding withholding taxation in the Source Country. This state of affairs means that the application of the GloBE measures to the UPE jurisdiction will not be avoided if a Source Country sets out a comprehensive withholding tax system on payments carried out for non-residents. Ultimately, a QDMTT may be a useful compensation mechanism for a Source Country, when and if this jurisdiction is also a Residence Country, i.e. if it is an Intermediate Company Jurisdiction that imposes corporate income tax on profits earned abroad. On the other hand, the QDMTT does not ensure that withholding tax – levied on outgoing payments – will be considered in the ETR calculation, and that the tax sovereignty of Source Countries will be protected with regard to withholding taxation.

3.3. The effects on withholding taxes imposed in Source Countries: Withholding tax disregarded from ETR calculations

In examining how Pillar Two deals with withholding tax, it is necessary not to disregard the effect that, according to article 4.1.1 of Pillar Two Model Rules, the term "adjusted covered taxes" – which is considered to be a numerator in the ratio to determine the ETR that triggers the GloBE measures – should be equal to the current tax expense accrued in the Financial Accounting Net Income of the Constituent Entity, adjusted by some additions and reductions provided in the Pillar Two Model Rules. These additions do not encompass withholding tax (except if charged on profits distribution under article 4.2.1 (b)) possibly levied on outgoing payments. In addition, article 4.2.2 of the Pillar Two Model Rules specifically provides that taxes charged in the Source Country due to adjustments made under a QDMTT or under a qualified UTPR will not be included in the sum of "adjusted covered taxes".

39. OECD, *Pillar Two Model Rules*, *supra* n. 2, at p. 65.
40. Arnold, *supra* n. 6, at sec. 3.4.
41. M. Lindgren, *"Two's Company, Three's a Crowd" – The Triad of Controlled Foreign Company Rules and the Two-Sided Income Inclusion Rule under the OECD's Pillar Two Global Minimum Tax Proposal*, 77 Bull. Intl. Taxn. 1 (2023), Journal Articles & Opinion Pieces IBFD.
42. A.P. Dourado, *Editorial: Pillar Two Model Rules: Inequalities Raised by the GloBE Rules, the Scope, and Carve-Outs*, 50 Intertax 4, pp. 1-4 (1) (2022).
43. J. Li, *The Pillar Two Model UTPR Departs from International Consensus and Tax Treaties*, 54 Tax Notes Intl. 105, pp. 1401-1410 (Mar. 2022); and M. Devereux, J. Vella & H. Wardell-Burrus, *Pillar Two: Rule Order, Incentives on Tax Competition*, Policy Brief, U. of Oxford (2022).
44. Arnold, *supra* n. 6, at sec. 3.4.1.
45. Id.
46. B.J. Arnold, *An Investigation into the Interaction of CFC Rules and the OECD Pillar Two Global Minimum Tax*, 76 Bull. Intl. Taxn. 6 (2022), Journal Articles & Opinion Pieces IBFD.
47. Lindgren, *supra* n. 41, at p. 21.
48. V. Chand, *The Interaction Between the Arm's Length Principle and Pillar II Global Minimum Tax Rules: A Technical and Policy-Oriented Analysis*, Institut für Finanzwissenschaft (IFF) Forum für Steuerrecht, Universität St. Gallen, pp. 365-387 (382) (2022).
49. V. Chand, A. Turina & K. Romanovska, *Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges*, 14 World Tax J. 1, sec. 7. (2022), Journal Articles & Opinion Pieces IBFD.

Here, an example may be helpful.

Suppose Company D is located in Country D and pays interest to Company E, located in Country E. Country D imposes a 25% withholding tax on outgoing interests, which is deductible for corporate income tax purposes levied, in turn, at a rate of 10%. In this situation, interests paid abroad counts as an effective 15% charge in respect of income tax.

Nevertheless, were Country E to adopt a typical IIR, the withholding tax levied on interest would not be considered for the purpose of determination of the ETR. Due to this position, from Country E's perspective, such an interest payment could be considered to be undertaxed, as the withholding tax would not be computed in the determination of the ETR, and would reduce Company's D corporate income tax base.

The exclusion of withholding tax (levied in Country D) from "adjusted covered taxes" leads to an ETR of less than 15%, giving rise to, as consequence, the application of the IIR in Country E.

This example illustrates how the withholding tax in the controlled entity country could be decisive in the determination of the ETR, and could then avoid the necessity of the application of the GloBE Rules in the UPE jurisdictions.

4. How ETR Criteria Neutralize Source-Country Tax Incentives: Pillar Two Objectives and the Restricted Carve-Out

The ETR criteria do not only disregard withholding tax for the purposes of the application of the GloBE Rules, but also neutralize benefits from most of the relevant tax incentives granted by Source Countries by way of the provision of a very narrow carve-out.[50] Such an approach to tax incentives relies on the objectives of Pillar Two – which are even broader than those established by the Actions of the OECD/G20 BEPS initiative[51] – being concerned with a minimum level of taxation for MNCs, thereby ruling out any possible advantages arising from favoured taxation.

Until Action 5, the OECD's focus was on cases in which profits were declared in low-tax countries, without there being a substantial activity there. In this case, it was understood that, as long as it was not a mere diversion of profits but, rather, a genuine allocation of activities, this would not be a case of profit shifting, as each country could freely tax the value created in its jurisdiction. From this perspective, if a jurisdiction could attract effective investment, despite being by way of tax incentives, there would be nothing to condemn. When it comes to minimum taxation and if the carve-out is established only for low-profit activities and tangible assets, there is a change in the level and in the proposed taxation of the "residual profits" that become most expressive than the routine profits taxed by the state in which the substantial activity is located. That is to say, the use of tax incentives, in principle, entails a new limit.[52]

In light of the foregoing, the OECD has advanced the concept of a global minimum taxation as a supposed result of multilateralism and antagonistic approach of international organizations and a group of countries (i.e. the G7) adopting inclusive sovereignty[53] among states. The creation of the Inclusive Framework can be upheld as an effort to grant legitimacy to Pillar Two, as it invites the non-OECD countries to the discussion. Nevertheless, the Pillar Two proposals did not result from a specific decision of the countries involved but, rather, from the G7 countries. Despite its technical capacity, the OECD lacks the legitimacy to represent the interests of countries[54] (especially that of developing countries). For this reason, the OECD has been dubbed as a "rich countries club".[55] Rather, it gives rise to an environment that compels developing countries to make an appearance (least they are considered to be uncooperative), and yet they are not really experiencing participation on equal footing.[56] Dagan (2017) even argues that voluntary cooperation in a system is not proof, in itself, that the system benefits all of its participants.[57]

Moreover, the fact should not be disregarded that, during the negotiations regarding Pillar Two in mid-2021, nine countries opposed it.[58] Among these countries, Estonia,[59] Hungary[60] and Ireland[61] and were the EU ones, and, although they counted for just 4% of EU's economic output,[62] they could have ruined the OECD's plan, as tax directives in the European Union require the unanimous consent of all of the 27 Member States.[63] Recently, the Member States of the European Union have given their approval plan following the granting some concessions

50. L.E. Schoueri, *Some Considerations on the Limitation of Substance-Based Carve-Out in the Income Inclusion Rule of Pillar Two*, 75 Bull. Intl. Taxn. 11/12, secs. 3. and 4. (2021), Journal Articles & Opinion Pieces IBFD.
51. Pistone et al., *supra* n. 1; Englisch & Becker, *supra* n. 1; and Cipollini, *supra* n. 1.
52. L.E. Schoueri & B.C. Fettermann Nogueira dos Santos, *Pillar Two and Global Tax Governance between Liberal International Order and Westphalian Order*, in *Anais do IX Congresso de Direito Tributário Internacional – IBDT/ DEF-USP: Tributação Internacional e Recuperação Econômica: o Papel dos Países Emergentes* pp. 471-507 (L.E. Schoueri, L.F. Neto & R.M. Silveira eds., IBDT 2022).
53. R.C.L. Pereira, *Cooperação Fiscal Internacional e Troca de Informações* p. 92 (IBDT 2020).
54. L.E. Schoueri & R.C.L. Pereira, *Governança Fiscal Internacional: entre a fragmentação e o déficit de legitimidade*, 15 Revista de Direito Internacional Econômico e Tributário 2, pp. 432-490 (440) (July/Dec. 2020).
55. Y. Brauner, *What the BEPS?*, 16 Fla. Tax Rev. 2, p. 59 (2014).
56. Oguttu, *supra* n. 4 and A. Christians, *OECD Secretariat's Unified Approach: How to get things on a truly Equal Footing*, Intl. Ctr. Tax & Dev., Blog (5 Nov. 2019), available at www.ictd.ac/blog/oecd-secretariat-unified-approach-equal-footing/ (accessed 12 July 2023).
57. T. Dagan, *International Tax Policy Between Competition and Cooperation*, p. 9 (Cambridge U. Press 2017).
58. Avi-Yonah & Kim, *supra* n. 18, at p. 42.
59. T. Buell, *Estonian Official Airs Country's Objections To Global Minimum Tax*, Law 360 (16 July 2021), available at www.law360.com/tax-authority/international/articles/1403781/estonian-official-airs-country-s-objections-to-global-minimum-tax (accessed 12 July 2023).
60. E. Lamer, *Growing Unease in EU Over Global Tax Deal's Next Steps*, Tax Notes (12 July 2021), available at www.taxnotes.com/tax-notes-today-international/corporate-taxation/growing-unease-eu-over-global-tax-deals-next-steps/2021/07/12/76rz4?highlight=OECD (accessed 12 July 2023).
61. L. Alderman, *Ireland's Days as a Tax Haven May Be Ending, but Not Without a Fight*, New York Times (12 July 2021), available at www.nytimes.com/2021/07/08/business/ireland-minimum-corporate-tax.html (accessed July 12 2023).
62. Avi-Yonah & Kim, *supra* n. 18, at p. 42.
63. Id.

regarding the wording of the proposed directive,[64] except for Hungary, which has restated its opposition recently.[65]

In addition to the opposition of some relevant countries, Pillar Two demonstrates that its proposal benefits only some of the member countries of the Inclusive Framework. It does this by establishing a carve-out that is undoubtably restricted, as it adopts as indicators (by way of a proxy) the concept of "substantial activity", and payroll expenses together with the depreciation and amortization of certain fixed assets (to encompass companies with less mobile capital). Such a restriction, however, unduly equates "economic substance" with the generation of profits by way of tangible assets. This stance means that countries could provide tax incentives for bricks and mortar activities, but not for activities that require greater specialization and that tend to generate effectively development in a given country.[66]

Due to the great limitations of the proposed carve-out, only a very modest profit margin is excluded from the scope of the Pillar Two Rules, such that profits that are considered to be "residual" are, in fact, economically relevant to the jurisdiction in which they were created. Accordingly, the OECD has contradicted its original intention to align taxation with the generation of value added.[67]

Moreover, this position reflects a paternalistic bias (which blames ultimately inefficient tax benefits on developing countries by assuming such countries to be weak and susceptible to pressure from MNCs).[68] Such a situation condemns developing countries to being able only to attract unprofitable investment, thereby perpetuating the gap between them and developed countries. More profitable investment, which imply greater value added, are not part of the carve-out, and, therefore, such profits are not encouraged to be sourced in countries with precarious infrastructures, as is the case with many developing countries.

For instance, Avi-Yonah and Kim (2019) endorse this paternalistic perspective in referring to the fact that developing countries grant tax holidays not because they wish to attract FDI but because MNEs threaten going elsewhere. In this sense – in the authors' opinion – the GloBE Rules would neutralize the behavioural incentives of multinational taxpayers to engage in location shopping. This, in turn, relies on the understanding the developing countries are very vulnerable to the power of MNEs, such that developing countries would need to interfere in the imposition of global top-up taxation.[69]

Conversely, the Tax Justice Network (TJN) and Oxfam have criticized the global minimum taxation as an unfair mean to afford advantages to wealthier countries.[70] Accordingly, in their view, the OECD would be pandering to tax havens and MNCs by offering them exemptions and loopholes with no revenue sharing for the world's poorest countries. In this sense, the requirement of an ETR would ensure that these countries provide for a minimum of taxation, as any tax incentive would be nullified. This position ignores the fact that, were it not for the incentives, the investments would not even have been made in these jurisdictions.

Carve-outs should be considered at least to protect tax incentives granted by developing countries so as to benefit investment in infrastructure[71] (although any and all investment should be stimulated through fiscal incentives policies). Along these lines, in 1986, the UN General Assembly adopted Resolution 4, which brought about the Declaration on the Right to Development (DRTD).[72] Article 3(3) of the DRTD states that states have a "duty to cooperate with each other to ensure development and eliminate obstacles to development". This duty extends to all fields, and there is no reason to exclude it from taxation. Consequently, if a state adopts measures that ensure its development (including attracting substantial activity to its territory), such measures should not be frustrated by unilateral countermeasures by other states.[73]

By designing a top-up tax rule and a restricted carve-out, the Pillar Two proposal ensures taxation in the Residence Country of groups of MNCs. This certainly favours Residence Countries, which are typically exporters of capital, that, to a large extent, are represented by developed countries and by the OECD member countries themselves (which perhaps explains, politically, why this design of rule).

Accordingly, it can be concluded that Pillar Two does not strengthen fiscal sovereignty, abstractly or even universally, but, rather, the tax sovereignty of the countries that host multinational groups. In this sense, Ibarrola (2021) states that the OECD is acting cynically when it argues that Pillar Two does not affect the sovereignty of countries. This fact should not be denied nor even hidden by the OECD.[74]

64. European Commission, *Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union* (2021/0433 CNS), 22.12.2021.
65. M. Kasnyik & W. Horobin, *EU Clashes With Hungary Over Implementing Global Minimum Tax*, Bloomberg (17 June 2022), available at: www.bloomberg.com/news/articles/2022-06-17/hungary-to-oppose-global-minimum-tax-at-eu-meeting-gulyas-says (accessed 9 July 2023).
66. Schoueri, *supra* n. 50.
67. OECD, *Action 8-10 Final Report 2015 – Aligning Transfer Pricing Outcomes with Value Creation* (OECD 2015), Primary Sources IBFD, also available at https://doi.org/10.1787/9789264241244-en (accessed 3 Sept. 2021).
68. B.J. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12, sec. 6.3.2. (2019), Journal Articles & Opinion Pieces IBFD, p. 644.
69. Avi-Yonah & Kim, *supra* n. 18, at p. 37.
70. H. Boland-Rudder & S. Woodman, *136 Countries agree to Global Minimum Tax for Corporations in 'Historic' OECD Deal*, Intl. Consortium Investigative Journalism (8 Oct. 2021).
71. Cipollini, *supra* n. 1.
72. *United Nations Declaration on the Right to Development (DRTF)*, available at www.ohchr.org/Documents/Issues/Development/RTD_booklet_en.pdf (accessed 9 Feb. 2021).
73. M.J. Silva, *Da Competição à Cooperação Internacional: Aspectos Jurídicos da Promoção do Desenvolvimento Nacional num Cenário Internacionalizado*, Tese de Doutorado apresentada à Faculdade de Direito da Universidade de São Paulo p. 176 (2009), available at https://teses.usp.br/teses/disponiveis/2/2133/tde-11112011-092811/publico/tese_mauro_jose_silva_1522522_versao_integral.pdf (accessed 30 Aug. 2021).
74. A.N. Ibarrola, *Consideraciones de Política Fiscal sobre la Propuesta Globe de Tributación Mínima (Pillar Two) y su Implementación*, Crónica Tributária, No. 179/2021, p. 63-91 (73).

In this sense, it should be noted that Pillar Two is based on the false assumption that all countries have the same internal economic conditions and offer the same level of public goods and services to investors. It is precisely because of this real inequality between countries that many offer tax benefits. Englisch and Yevgenyeva (2013) explain this situation by stating that countries, as a rule, seek a certain compatibility between the tax burden they impose and the services and public goods they offer.[75] In the same vein, Cipollini (2020) speaks of "fiscal residue" as the net benefit resulting from the difference in spending on infrastructure and the amounts collected. He argues that some countries have limited resources with which to carry out "public spending" on infrastructure development for their investors, and, therefore, must legitimately be able to impose low taxation – what the author refers to as "low-tax, low-spend".[76] In admitting, however, this relationship, it then seems reasonable that two competitors operating in the same country (benefited, therefore, by the same infrastructure and the same public goods and services) should be subject to the same tax burden. With that, any tax imposition in addition to this general level of territorial taxation would distort competition, and taxpayers would bear increased costs without any return.[77] This argument of course favours Capital Import Neutrality, which Pillar Two appears to contradict.

It should not be disregarded that the UTPR, in its turn, also restricts the unilateral concession of tax incentives, but by Residence Countries. If the ETR does not reach the minimum tax rate for Residence Countries (due to tax incentives, for example), Source Countries will be allowed to tax payments so that low taxation in Residence Countries can be dealt with.

5. How ETR Criteria Neutralize Tax Sparing and Matching Credit Benefits

The ETR criteria also hinder source taxation, as they damage the beneficial effects granted by tax sparing and matching credit clauses by double taxation treaties. The reasoning behind this statement is now set out.

First, the Pillar Two proposals rely on the determination of the ETR according to a jurisdictional blending. In this context, Andrade Rodríguez elucidated that the effective impact of the GloBE Rules (specially the IIR) on tax sparing clauses varies depending on the blending approach adopted by the Pillar Two proposal.[78] Worldwide blending, for example, would allow the mixing of high- and low-income tax, such that income subject to a lower tax rate due to tax incentives (and protected by tax sparing rules) would, possibly, not accrue to a top-up tax at the minimum rate. Nevertheless, as noted in section 3., the Pillar Two proposals indicate that the jurisdictional approach should be adopted, so minimum taxation should be achieved on a country basis. This approach may reveal that the ETR is below the minimum tax rate in a country granting tax incentives to be protected by tax sparing clauses, and, therefore, will give rise to the levying of the IIR.[79]

Second, as the presumed tax credit granted in the Residence Country – due to a tax sparing clause – is not computed as paid tax in the Source Country, so it is not included in the calculation of the ETR, as is explained in more detail as follows.

According to article 4.1.3 of the Pillar Two Model Rules, tax credits granted without corresponding to paid tax[80] will not be computed as the "adjusted covered taxes". As is stated in the Commentary to the Pillar Two Model Rules, a "non-qualified refundable tax credit" entails tax credit that is not a "qualified refundable tax credit"[81] (which encompasses, in turn, a refundable tax credit that must be paid in cash). A tax credit that reduces "covered taxes" (i.e. any kind of corporate income tax expense registered in the financial statements), but which is not refunded in cash, is not considered to be a "qualified refundable tax credit".

In this sense, the Pillar Two Model Rules and the Pillar Two Commentary to the Pillar Two Model Rules[82] appear (because they do not provide it expressly) to consider tax sparing and matching credit benefits to be a "non-qualified refundable tax credit" that, on the one hand, will not reduce the "adjusted covered taxes", but also, on the other hand, will not be fictitiously computed as taxes paid for purposes of the calculation of the ETR. When a tax treaty includes for tax sparing or matching credit clauses, the fictional credit received in the Residence Country qualifies for the same treatment given to a withholding tax that would have been paid in the Source Country. This same logic should also be observed in the assessment of the ETR. When the ETR does not consider the fictional credit, the Residence Country should apply the IIR, which will effectively reverse the effects of the tax sparing or matching credit granted by a tax treaty.

In any case, even if the credits granted by tax sparing and matching credit were to be considered as a "qualified refundable tax credit", they would reduce not only the "adjusted covered taxes", but also would be added to the "GloBE income" according to article 3.2.4 of the Pillar Two Model Rules.[83] In sum, the effect of the tax sparing and matching credit clauses would be reduced, as they would be considered in the numerator (the "adjusted covered taxes") just as with the denominator (the "GloBE income") of the ratio used to calculate the ETR.

75. J. Englisch & A. Yevgenyeva, *The Upgrade Strategy Against Harmful Tax Practices Under the BEPS Action Plan*, Brit. Tax Rev. 5, p. 620-637 (626) (2013).
76. Cipollini, *supra* n. 1, at sec. 6.2.
77. O. Gandenberger, *Kapitalexportneutralität versus Kapitalimportneutralität*, 7 Aufsätze zur Wirtschaftspolitik. Forschungsinstitut für Witschaftspolitik na der Universtät Mainz (1983) and K. Vogel, *Worldwide vs. Source Taxation of Income – A Review and Reevaluation of Arguments*, in *Influence of Tax Differentials on International Competitiveness* p. 117-166 (140) (P.B. Musgrave, C.Jr. McLure & H.-W. Sinn, Kluwer L. & Taxn. 1990).
78. Andrade Rodríguez, *supra* n. 21, at sec. 7, p. 25.
79. Id.
80. OECD, *Pillar Two Model Rules*, *supra* n. 2, at p. 23.
81. OECD, *Commentary to the Pillar Two Model Rules*, *supra* n. 3, at p. 215.
82. OECD, *Pillar Two Model Rules*, *supra* n. 2, at p. 16 and *Commentary to the Pillar Two Model Rules*, *supra* n. 3, at p. 64.
83. OECD, *Pillar Two Model Rules*, *supra* n. 2, at p. 16.

In this sense, the legitimate choice of a Source Jurisdiction not to tax income derived from its territory should be reduced by the Pillar Two measures due to the chosen ETR criteria. Indeed, this has much to do with the jurisdiction of countries in general and not just with taxation,[84] and their freedom to grant treaty benefits as they wish. Here, it should be noted that recently the Supreme Court of Canada (SCC) has upheld a taxpayer-favourable decision in stating that treaty bargains must be respected, even if they derive from treaty shopping.[85] Despite the particular specificity of this decision, it generally confirms the necessary preservation of treaty terms.

6. Conclusions

Despite all the furore surrounding the concept of minimal taxation and the apparent simplicity and unanimity on the topic as reported inadvertently by the media, the Pillar Two proposal rests on many inconsistencies and half-truths. These are considered below.

The primary half-truth derives from the fact that the calculation of the ETR brings complexity[86] to the measures and relies on criteria that hinder source taxation. In this sense, the Pillar Two Model Rules set out a rule ordering that places the UTPR over the IIR and the qualified IIR. This reduces even more the share of tax jurisdiction afforded to Source Countries.

Although the QDMTT may be considered to be compensation for Source Countries, it is to be provided by corporate income taxation rules and has nothing to do with withholding tax, the latter, by the way, that is broadly adopted by developing countries due to the ease of administration. In that regard, the QDMTT would give rise to a restricted positive effect on source taxation.

In addition to hindering the imposition of withholding taxes by Source Countries, Pillar Two hampers their freedom to grant relevant tax incentives to attract FDI. Due to the narrow carve-out of Pillar Two, relevant tax incentives given by Source Countries would be neutralized in Residence Countries by the application of the GloBE Rules. With this very same line of reasoning and still regarding the concession of tax incentives, the Pillar Two proposals appear to reduce the effects of tax sparing clauses, as jurisdictional blending is adopted to calculate the ETR and the presumed credit derived therefrom will be minimized in the calculation of the "adjusted covered taxes" or of the "GloBE income" as noted in section 5.

In sum, this article has addressed how the ETR criteria (as defined by the Pillar Two Model Rules and the Commentary to the Pilar Two Model Rules) have (a negative) effect on three main aspects of source taxation. These are: (i) withholding taxes; (ii) concessions in respect of tax incentives; and (iii) the recognition of tax sparing and matching credit rules. These tools guarantee the efficiency of tax domestic measures adopted by Source Countries and their tax sovereignty. Ultimately, the OECD merely reflects the national interests (of some rich countries) in presenting a false impression to being a properly autonomous representative of global interests (expressly by the creation of the inclusive framework). This position should be contrasted with the reality of the situation with regard to which the OECD can be considered to be an empty shell,[87] encompassing not global concerns revealed after considerable multilateral debate, but, rather, effectively the paternalist desires of developed countries worried about guaranteeing their own tax sovereignty at the expense of that of developing countries.

84. B. Ferreira Liotti, *Limits of International Cooperation: The Concept of "Jurisdiction Not to Tax" from the BEPS Project to GloBE*, 76 Bull. Intl. Taxn. 2, sec. 4.1. (2022), Journal Articles & Opinion Pieces IBFD.
85. CA, SSC, 11.26.2021, *Alta Energy Luxembourg S.A.R.L. v. the Queen*, 2021 SCC 49, upholding the decision of the Canadian Federal Court of Appeal (CFCA) in CA: CFCA, 12 Feb. 2020, *Alta Energy Luxembourg S.A.R.L. v. the Queen*, 2020, FCA 43, Case Law IBFD.
86. A. Lanthier, *Why Pillar Two should be abandoned*, MNE Tax (28 Mar. 2022), available at https://mnetax.com/why-pillar-two-should-be-abandoned-47088 (accessed 12 July 2023).
87. M.N. Barnett & M. Finnemore, *The Politics, Power, and Pathologies of International Organizations*, 53 Intl. Org. 4, pp. 699-732 (1999), available at www.cambridge.org/core/services/aop-cambridge-core/content/view/S002081839944086X (accessed 22 Mar. 2023).