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An Analysis of Controlled Foreign Company Rules, the OECD's Pillar Two and Developing Countries

The author, in this article, discusses how developing countries could be affected by the developments initiated by the OECD by asking the following two research questions. How would developing countries be affected by adapting controlled foreign company regulations and Pillar Two? Are the interests of developing countries protected at all?

1. Introduction

Discussions on the necessity of legal regulations regarding the taxation regime of controlled foreign companies (CFCs)[1] began with the OECD report published in 1998.[2] Following that, it returned to the agenda by way of the G20 Summit and the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project in 2015.[3] This was not surprising, as, during that time, developments and disclosed facts had revealed that some multinational enterprises (MNEs) had reduced their tax burdens through tax planning techniques, especially by using CFCs.[4] Before the advent of CFC rules, countries mostly tried to prevent this type of revenue loss by implementing general anti-tax avoidance rules (GAARs). However, the success of these measures was arguable.[5] Many studies have demonstrated that the primary reason for such tax planning schemes being preferred by MNEs was the different tax rates applied by states,[6] and the fact that the source of the problem was the differences in tax systems in the first place. Accordingly, the regulations regarding the taxation of CFC earnings have been favoured by states as special tools to counter tax avoidance plans and profit shifting through the abuse of tax rates,[7] as well as being considered to be a solution.[8]

The implementation of CFC regulations has been a long process[9] that first started in the late 1930s in the United States, and resulting in the introduction of the first anti-deferral rule there by way of Public Law 86-780 in 1960[10] in the (long-term) aftermath of World War II. The initial aim was to obtain information on the overseas activities of US corporations given the political and economic developments that encouraged the international expansion of US businesses.[11]This was followed by the enactment of Revenue Law of 1962 (Subpart F),[12] which has been amended several times over the years. Subpart F requires US shareholders to include in their gross income the pro-rata share of the passive income of the CFC. As stated by the US Department of the Treasury, the enactment of Subpart F rules was the result of the following main reasons:[13]

- preventing the abuse of tax havens;
- taxing passive income in a timely manner whether or not such income was earned through a tax haven;

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1. P.K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive – An Interim Nordic Assessment*, 2 Nordic Tax J., pp. 87-112 (2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3290050 (accessed 4 Dec. 2023).
2. *See* OECD, *Controlled Foreign Company Legislation* (OECD 1996) and *Report Harmful Tax Competition: An Emerging Global Issue* (OECD 1998).
3. OECD, *Action 3 Final Report 2015 – Designing Effective Controlled Foreign Company Rules*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD [hereinafter the *Action 3 Final Report* (2015)].
4. *See* OECD, *New OECD data highlight multinational tax avoidance risks and the need for swift implementation of international reform* (OECD 2022), available at www.oecd.org/tax/new-oecd-data-highlight-multinational-tax-avoidance-risks-and-the-need-for-swift-implementation-of-international-reform.htm (accessed 23 Nov. 2023).
5. The success of the EU-level GAAR is also open to question. *See*, for example, C. Öner, *General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: Another Brick in the Wall to Prevent Tax Avoidance?*, in *Tax Planning and Tax Avoidance After BEPS: A Legal and Economic Analysis* (*Conceptos De Abuso, Planificación Fiscal, Planificación Fiscal Agresiva Y Erosión Y Desplazamiento De Bases Imponibles En La Era Post BEPS)* pp. 319-337 (J.A. Martínez de Pisón & F.D. Martínez Laguna eds., Thomson Reuters 2022) and *Comparative Analysis of the General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: An Effective Tool to Tackle Tax Avoidance?*, 29 EC Tax Rev. 1, pp. 38-52 (2020).
6. N. Lee & C. Swenson, *Effects of Overseas Subsidiaries on Worldwide Corporate Taxes*, 26 J. Intl. Acctg., Auditing & Taxn., pp. 47-59 (2016).
7. This is often carried out using preferential tax regimes or tax havens. *See* R. Grant & G. Taylor, *Income Shifting Incentives and Tax Haven Utilization: Evidence from Multinational US Firms*, 50 Intl. J. Acctg. 4, pp. 458-459 (2015).
8. M.A. Kane, *The Role of Controlled Foreign Company Legislation in the OECD Base Erosion and Profit Shifting Project*, 68 Bull. Intl. Taxn. 6/7, sec. 2 (2014), Journal Articles & Opinion Pieces IBFD.
9. L. Ostorero, *Historical Background to CFC-Rules and Policy Considerations Historical Background to CFC-Rules and Policy Considerations*, in *Concept and Implementation of CFC Legislation, Series on International Tax Law*, vol. 124, p. 4 (N. Bravo & A. Miladinovic eds., Linde 2021).
10. US: Public Law 86-780, 14 September 1960, available at www.govinfo.gov/content/pkg/STATUTE-74/pdf/STATUTE-74-Pg1010.pdf#page=4 (accessed 16 Nov. 2023).
11. M. Redmiles & J. Wenrich, *A History of Controlled Foreign Corporations and the Foreign Tax Credit*, p. 132 (US Internal Revenue Service (IRS)), available at www.irs.gov/pub/irs-soi/historycfcftc.pdf (accessed 16 Nov. 2023).
12. US: Revenue Act of 1962, Public Law 87-334, 16 October 1962, sec. 12, available at www.govinfo.gov/content/pkg/STATUTE-74/pdf/STATUTE-74-Pg1010.pdf#page=4 (accessed 16 Nov. 2023).
13. US: Office of Tax Policy Department of the Treasury, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study (Dec. 2000), ch. 2, The Intent of Subpart F (2000), available at https://home.treasury.gov/system/files/131/Report-SubpartF-2000.pdf (accessed 16 Nov. 2023).

– promoting equity among US taxpayers through the concept of tax neutrality and/or efficiency;
– promoting economic efficiency; and
– encouraging the competitiveness of US-owned foreign corporations with the aim of stimulating investment abroad.

Meanwhile, other countries tried to minimize tax losses by updating existing rules or adding new tax avoidance tools to their tax systems.[14] These regulations resulted in the taxation of profits from low-tax subsidiaries in the jurisdiction of the headquarters of MNEs. Consequently, the possibilities for profit shifting by an MNE headquartered in a country with effective CFC rules were anticipated to be reduced significantly.

Given this, CFC rules aim to protect the tax base of the countries in which the controlling parent company is resident. These are mostly developed countries.[15] International taxation rules generally provide that a country has the right to tax income and gains if they arise within its jurisdiction, or if they accrue to a person resident in that country. CFC legislation taxes the income that arises to a person not resident in that country and, most importantly, that is not earned in that country.[16] Consequently, there is a discussion in the literature questioning the legality of CFC regulations.[17] In addition, the compatibility of CFC regulations with tax treaties has been raised many times in case law and practice.[18] Leaving these issues aside, the author in this article aims to discuss how developing countries could be affected by the recent developments initiated by the OECD by asking the following two general research questions. How would developing countries be affected by adopting CFC regulations and the OECD's Pillar Two? Are the interests of developing countries protected at all?

14. One of the most specific examples of such efforts can be observed at the EU level. Among other things, Council Directive (EU) 2016/1164 of 12 July 2016, Laying Down Rules Against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market, OJ L 193 (2016), Primary Sources IBFD [hereinafter the Anti-Tax Avoidance Directive (2016/1164) (ATAD) (2016)] makes it compulsory to enact a tax system in respect of CFC earnings and all other measures to prevent tax avoidance into the domestic laws of the Member States.
15. This article uses the United Nations (UN), World Economic Situation and Prospects (WESP) country classification for analytical purposes. In this regard, all countries of the world are divided into one of the following three broad categories: (i) developed economies; (ii) economies in transition; and (iii) developing economies. This classification reflects basic economic conditions in the country. *See* UN, *World Economic Situation and Prospects* (UN 2023), available at https://unctad.org/system/files/official-document/wesp2023_en.pdf (accessed 16 Nov. 2023).
16. L. Oats, *Principles of International Taxation*, pp. 408-409 (8th ed., Bloomsbury Prof. 2021).
17. *See*, for example, D. Sandler, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries*, p. 3 et seq. (2nd ed., Kluwer L. Intl. 1998).
18. *See*, for example, the decision of the French *Conseil d'État* (Supreme Administrative Court, CE) in FR: CE, 28 June 2002, Case 232276, *Schneider Electric*, Case Law IBFD; that of the Finnish *Korkein Hallinto-oikeus* (Supreme Administrative Court, KHO), in FI: KHO, 20 Mar. 2002, Case 20.03.02/596; KHO: 2002:26, *Re A Oyj Abp*, 4 ITLR 106, 1009, Case Law IBFD; and that of the UK Court of Appeal of England and Wales (CAEW), in UK: CAEW, 27 June 1997, *Bricom Holdings Ltd. v. Commissioners of Inland Revenue*, STC, p. 1179 (1997), Case Law IBFD.

2. CFC Rules

2.1. The need for CFC rules

According to the OECD,[19] the current CFC rules often do not keep up with changes in the international business environment, and most of them are not designed to grasp base erosion and profit shifting effectively.[20] For instance, as a first method, many countries consider subsidiaries to be legal entities separate from their shareholders. As a result, corporate income could be taxed as shareholder income only when dividends are distributed or company shares are sold. A second method could be taxing the incomes of taxpayers with limited and full liability differently. This difference arises from taxing the income either according to the principle of universality or territoriality. Such an approach, inadvertently and interactively, paved the way for tax avoidance. Sometimes, CFCs are not the subject of a tax burden on their own accord, as they do not have a direct link with the country as a limited tax-liable company. On the other hand, the controlling resident company can create tax avoidance opportunities by using its influence on the CFCs.[21] In practice, in general, the controlling company decides when the dividends will be distributed, or when the shares will be disposed of, thereby creating an opportunity to postpone the tax burden. In this respect, a postponement in taxation has a reducing effect on tax revenues in respect of states that have adopted the principle of territoriality.[22,23]

Nevertheless, it is open to debate whether CFCs could potentially provide tax advantages through tax deferral in the long term if the income is not recycled through other arrangements.[24] It is claimed that the CFCs mainly plan to gain a tax advantage by using the differences in tax rates.[25] In any case, CFC rules should aim to prevent income from being directed to states that implement low-tax regimes (profit shifting) or to delay the acquisition of income (base erosion) in these states.[26] Accordingly, the target of CFC rules is multinational companies (MNCs) with access to different states and tax rules with sufficient resources to

19. OECD, *Action 3 Final Report* (2015), *supra* n. 3, at p. 9.
20. Id.
21. R.S. Avi Yonah & O. Halabi, *US Subpart F Legislative Proposals: A Comparative Perspective*, U. Mich. L. & Econ Research Paper No. 12-003 and U. Mich. Pub. L. Working Paper No. 264, p. 2 (2012), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1991966 (accessed 16 Nov. 2023).
22. Another fact that should be evaluated is that tax deferral could have a positive result in terms of attracting foreign investments to the country. *See* OECD, *Controlled Foreign Company Rules* pp. 16-17 (OECD 1998).
23. In addition, if national law excludes dividends or capital gains generated abroad from tax for a while, it means that such income will never be taxed. For instance, according to Singapore's national tax law, income earned abroad is not taxed until it is brought into the country. *See* N. Lingbawan, *Singapore – Corporate Taxation*, sec. 6.1., Country Tax Guides IBFD.
24. The deferral can be characterized as an "unintentional by-product of the fundamental tax principles that a foreign corporation is a separate taxable entity and is usually considered to be non-resident for tax purposes". *See* B.J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, 78 Can. Tax Papers, p. 83 (1986).
25. Y. Brauner, *What the BEPS*, 16 Fla. Tax Rev. 55, p. 87 (2014).
26. P. Baker, *CFC Aspects of Intellectual Property*, in *Tax Aspects of Research and Development within the European Union* pp. 135-144 (N. Włodzimierz & A. Zalasiński eds., Wolters Kluwer 2014) and Oats, *supra* n. 16, at p. 399 et. seq.

exploit these differences and/or incompatibilities between tax systems in a way that gives rise to tax advantages.[27,28]

2.2. Economic needs of developing countries and CFC rules

As a primary argument, it can be said that CFC regulations are preferred primarily by the states that exported capital. On the other hand, it can be observed that, day by day, developing countries are also including similar regulations in their legislation at an increasing rate.[29] For instance, Brazil, China, Indonesia, Russia, South Africa and Turkey are all states that added CFC tax regulations to their systems even before the OECD/G20 BEPS Project. In other words, as developing countries have developed, they have also started to encounter the problems faced by developed states.[30]

The economic overview and needs of a developing country can be linked to CFC rules in several ways. Initially, adhering to international standards and promoting fair competition is crucial for the economic development of developing countries. Implementing CFC rules aligns with global efforts to counter tax evasion and maintain a level playing field for businesses. With the integration of local economies and markets in the last two decades, there has been a change from country-specific operating models to global management organizations and other models based on integrated supply chains that centralize various functions globally.[31]

In addition to these matters, the globalization of trade and investment has encouraged developing states to implement tax policies that attract foreign direct investment (FDI) to their countries and increase their tax revenues.[32] Developing countries typically seek to attract FDI to stimulate economic growth. However, there is a risk that MNCs may exploit the conditions that created mismatches between the tax systems of states in terms of applied tax rates and taxation techniques, making it almost attractive for some investments to turn to tax havens or states with preferential tax regimes. CFC rules can provide a balance by ensuring that, while attracting FDI, the host country is also able to tax the income generated by foreign subsidiaries, preventing erosion of the domestic tax base.[33]

For this reason, sister companies or subsidiaries are considered to be controlled financially by the residents of states with high tax rates, and these companies are often referred to as controlled foreign entities from the perspective of those states in which they reside. In various empirical studies,[34] it has been demonstrated that the pre-tax profits of MNCs with subsidiary companies in states that apply low-tax regimes are higher than their tax burdens. While the author perceives this to be contentious, the assertion is made that this suggests the presence of tax avoidance.[35] Moreover, CFC rules can support the growth of domestic industries by preventing MNCs from gaining an unfair advantage. This helps foster a competitive environment that encourages the development of local businesses. Addressing tax avoidance through CFC rules can also help to reduce income inequality by ensuring that wealthy individuals and corporations pay their fair share of taxes. In summary, the economic challenges faced by developing countries, such as capital flight, tax evasion and the need for revenue generation, provide a strong rationale for implementing CFC rules.

2.3. CFC rules from a tax policy perspective

Change is inevitable in the tax arena as every field and taxation is expected to be more beneficial to society than a burden. However, it is still helpful to consider the taxation principles developed by Adam Smith[36] when updating tax systems.[37] In the design of tax rules that have a global

27. However, it is imperative that CFC rules follow a balanced path between the tax advantage to be gained (even with the tax loss that may arise) and the other advantages in the international markets. *See* B. Kuźniacki, *The Need to Avoid Double Economic Taxation Triggered by CFC Rules under Tax Treaties, and the Way to Achieve It*, 43 Intertax 12, pp. 758-772 (2015); S. Keller & D. Schanz, *Measuring Tax Attractiveness across Countries*, *Arqus-Diskussionsbeiträge zur quantitativen Steuerlehre*, No. 143. *Kiel: Leibniz-Informationszentrum Wirtschaft*, pp. 31-32 (2013), available at https://pdfs.semanticscholar.org/cc9d/330a5f3a9e2e2bf6edc742af397669e822f8.pdf (accessed 16 Nov. 2023); and M.M. Hybka, *Legislative Proposal for a Controlled Foreign Companies Regime in Poland from an International Perspective*, 38 Fin. Theory & Prac. 4, pp. 465-487 (2014).
28. Low-tax or tax-advantage criteria alone may not be sufficient in activating CFC rules in all cases. With regard to the EU law context, *see* D.S. Smit, *Substance Requirements for Entities Located in a Harmful Tax Jurisdiction under CFC Rules and the EU Freedom of Establishment*, 16 Fin. & Cap. Mkts 6, sec. 2. (2014), Journal Articles & Opinion Pieces IBFD.
29. *See* P.A. Harris, *United Nations Handbook on Selected Issues*, in *Protecting the Tax Base of Developing Countries* pp. 65-66 et seq. (A. Trepelkov, H. Tonino & D. Halka eds., United Nations 2017).
30. *See* E. Crivelli, R. De Mooij & M. Keen, *Base Erosion, Profit Shifting and Developing Countries*, International Monetary Fund (IMF) Fiscal Affairs Dept., IMF Working Paper WP/15/118 (2015), available at www.imf.org/external/pubs/ft/wp/2015/wp15118.pdf (accessed 16 Nov. 2023). *See also* J. Niels, T. Tørslø & L. Wier, *Are Less Developed Countries More Exposed to Multinational Tax Avoidance? Method and Evidence from Micro-Data*, World Bank Econ. Rev., WIDER Working Paper, 2016/10, available at https://academic.oup.com/wber/article/34/3/790/5606636 (accessed 4 Dec. 2023).
31. OECD, *Addressing Base Erosion and Profit Shifting* p. 25 (OECD 2013), Primary Sources IBFD [hereinafter *Addressing Base Erosion and Profit Shifting*].
32. OECD, *Harmful Tax Competition: An Emerging Global Issue*, para. 8 et seq. (OECD 1998).
33. B. Kuźniacki, *Controlled Foreign Companies and Tax Avoidance: International and Comparative Perspectives with Specific Reference to Polish Tax and Constitutional Law, EU Law and Tax Treaties*, SSRN Working Paper, p. 27 (16 Mar. 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3107382 (accessed 16 Nov. 2023).
34. *See*, for example, Å. Johansson et al., *Tax Planning By Multinational Firms: Firm-Level Evidence From A Cross-country Database*, Economics Departments Working Papers No. 1355, ECO/WKP(2016)79, OECD (6 Feb. 2017), available at www.oecd.org/economy/public-finance/Tax-planning-by-multinational-firms-firm-level-evidence-from-a-cross-country-database.pdf (accessed 16 Nov. 2023).
35. For instance, C. Fuest & N. Riedel, *Tax Evasion and Tax Avoidance in Developing Countries: The Role of International Profit Shifting*, Oxford University Centre for Business Taxation Working Paper, p. 18 (2012).
36. Adam Smith, for example, defined the following four basic principles of the ideal tax system that are still valid today: (1) equity; (2) precision; (3) convenience; and (4) efficiency. *See* A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book 5, Chapter II, Part 3 of Taxes. According to Stiglitz, the five accepted features of a good tax system are: (1) efficiency; (2) administrative simplicity; (3) flexibility; (4) political responsibility; and (5) fairness. *See* J.E. Stiglitz, *Economics of the Public Sector* pp. 457-458 (3rd ed., WW Norton & Co. 1999).
37. C. Alley & D. Bentley, *A Remodeling of Adam Smith's Tax Design Principles*, Austrl. Tax Forum, No. 2, p. 586 (2005).

effect, such as CFC rules, the following points should be taken into account. CFC rules should not only focus on income maximization, but should also aim to promote equality, increase competition and ensure economic neutrality.[38] Well-designed CFC rules should ensure that states generate tax revenues in a fair system by protecting the tax base rather than simply expanding the tax base. Consequently, in determining the tax burden, it should be taken into consideration that taxpayers are not affected negatively, i.e. by double taxation.[39] In addition, it should be expected that the rules are administratively easy to apply and have characteristics that encourages compliance. One of the most critical factors that affects voluntary compliance is undoubtedly perceptions of justice and fairness.[40] These two principles are essential for international tax systems.[41] As tax relations in the international arena involve more than one state, understanding justice at that level should be evaluated from the perspective of all of the states included in the network, considering their cumulative effects on the relevant countries. Fair taxation can be achieved by contributing to the development of acceptable international standards, imposing a tax burden on taxpayers, and cooperating with other countries.[42] As a result, in designing national CFC rules, CFC rules applied in other states should also be considered. Establishing standardized or harmonized CFC regulations across the global tax framework would enhance competitiveness and investment appeal. Nevertheless, on the other hand, CFC rules are known as the most complex rules in tax systems and the principle of simplicity and clarity in taxation is mostly ignored.[43] Overly intricate and challenging rules that are hard to comprehend and apply may result in uncertainty and implementation issues, particularly for developing countries.

An additional pivotal aspect in the realm of tax policy considerations involves fostering economic growth.[44] It is suggested that making a country appealing to foreign investment is essential to promote economic expansion. In this context, some argue that imposing restrictions on outbound investment flows could upset the equilibrium in international tax policy and compromise the principles of import and/or export neutrality.[45,46]

Moreover, from the perspective of international tax law, CFC rules should not conflict with the provisions of tax treaties. In particular, CFC rules should be designed in accordance with the articles on the taxation of business profits and dividends. For instance, in the piercing-the-corporate-veil approach,[47] a CFC is considered to be a transparent entity and is ignored in terms of taxation. In the deemed-dividend approach,[48] the state in which the controlling company is resident has the authority to tax the dividends before they are distributed as if they were distributed. Under this approach, the CFC is acknowledged to be an entity but the practical aspects related to the actual occurrence of dividend distribution are disregarded. Consequently, taxpayers are subject to taxation as if they had earned income. Accordingly, there should be no conflict between the taxation powers of states lacking or possessing distinct CFC rules and the interests of states implementing such rules.

Taxing income by another state that is not subject to taxation in its own jurisdiction or has not been realized yet goes against the principles of the fair allocation of taxing rights that form the basis of tax treaties. The safeguarding of the interests of developing countries should also be ensured in this context. For instance, some tax treaties, i.e. the Belgium-Turkey Income Tax Treaty (1987)[49] and The Netherlands-Turkey Income Tax Treaty (1986),[50] in certain conditions, do not envisage any taxation, even though the dividends are distributed.[51,52] In such instances, the application of CFC rules would not align with the interests of developing countries.

3. Redesigning the Rules: The OECD's Plans

3.1. In general

According to the OECD, traditional tax systems cannot keep up with developments in the international business world and cannot effectively counter the tax avoidance strategies of MNCs because they cannot appreciate the

38. B.J. Arnold, *International Tax Primer* pp. 4-5 (3rd ed., Kluwer L. Intl. 2016).
39. S.A. Stevens, *The Duty of Countries and Enterprises to Pay Their Fair Share*, 42 Intertax 11, pp. 702-708. (2014).
40. F. Debelva, *Fairness and International Taxation: Star-Crossed Lovers?*, 10 World Tax J. 4, sec. 3.1 et seq. (2018), Journal Articles & Opinion Pieces IBFD.
41. Id., at sec. 3.2.
42. Arnold, *supra* n. 38, at p. 5.
43. D. Pinto, *A Proposal to Reform Income Anti-Tax-Deferral Regimes*, 12 J. Austrl. Taxn. 2, pp. 41 and 45 (2009).
44. Arnold, *supra* n. 38, at p. 5.
45. D.A. Weisbach, *The Use of Neutralities in International Tax Policy*, U. Chi. Chi. Unbound, Coase-Sandor Working Paper Series in Law and Economics, pp. 3-4 (2014), available at https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2383&context=law_and_economics (accessed 16 Nov. 2023).
46. It is also proposed that achieving the balance in cross-border transactions appears to be possible by recognizing the country of origin principle rather than residence. In this case, the principle of universality in taxation can be fully applied. In general, the principles of universality and territoriality find application in tax systems together. However, it is argued that CFC rules of the states that focus on the principle of territoriality are more comprehensive. *See* K.B. Brown, *Taxation and Development – A Comparative Study* p. 350 (1st ed., Springer Intl. Publg. 2017).
47. *See* A. Rust, *CFC Legislation and EC Law*, 36 Intertax 11, p. 493 (2008); D. Canè, *Controlled Foreign Corporations as Fiscally Transparent Entities. The Application of CFC Rules in Tax Treaties*, 9 World Tax J. 4, sec. 3.1. (2017), Journal Articles & Opinion Pieces IBFD; and M. Lang et al., *CFC Legislation, Tax Treaties and EC Law* p. 23 (4th ed., Kluwer L. Intl. 2004).
48. *See* Rust, *supra* n. 47, at p. 493 and Canè, *supra* n. 47, at sec. 3.1.
49. *Belg.-Turk. Income Tax Treaty* (2 June 1987) (as amended through 2013), Treaties & Models IBFD.
50. *Neth.-Turk. Income Tax Treaty* (27 Mar. 1986), Treaties & Models IBFD.
51. For various country applications, *see* B. Kuźniacki, *Tax Treaty Interpretation by Supreme Courts: Case Study of CFC rules*, available at www.ibdt.com.br/material/arquivos/Palestras/B_Kuzniacki_Supreme_Courts_Case_law_CFC_rules_and_tax_treaties_version%20from%20Sept_final.pdf (accessed 16 Nov. 2023). For the Turkish application *see* C. Öner, *Turkey: Taxation of CFC Earnings Before and After the Distribution of Dividends*, in *Tax Treaty Case Law around the Globe 2018* ch. 15 (E.C.C.M. Kemmeren et al. eds., IBFD 2019), Books IBFD.
52. R. Bräutigam, C. Spengel & F. Streif, *Decline of Controlled Foreign Company Rules and Rise of Intellectual Property Boxes: How The European Court of Justice Affects Tax Competition and Economic Distortions in Europe*, 38 Fiscal Stud. 4, p. 741 (2017). These authors demonstrate even possibly negative effects of the jurisprudence of the Court of Justice of the European Union (ECJ) on the internal market.

growing importance of the global value chain as a new business model.[53] In this context, the OECD/G20 BEPS Project primarily suggested that states strengthen their CFC rules and understand all of the considered practices that may give rise to tax losses.[54] Although the concept of strengthening[55] appears to target existing rules, it also includes establishing new ones.[56]

The businesses of MNCs abroad do not act independently from the company's general operating policies and strategies and, even if they can be considered to be apparently separate, they continue their activities in a completely integrated manner with the parent company. Accordingly, the OECD has investigated the reasons for the fragmentation or separation of the activities of companies in this manner. The results reveal a distinction between where the activities and investments were realized, and where the income was declared in the corporate structure.[57]

Then, in 2021, the OECD proposed the concept of global anti-base erosion in its report on Tax Challenges Arising from the Digitalization of the Economy - Global Anti-Base Erosion Model Rules (GloBE) (Pillar Two).[58] GloBE is intended to be a key component of the OECD/G20 BEPS plan to ensure large MNEs pay a minimum level of tax on the income arising in each of the jurisdictions in which they operate. The main objective declared is to curb profit shifting. Accordingly, GloBE can be regarded as a continuation of the OECD/G20 BEPS Project. The second objective is to address tax competition.[59]

In more precise terms, GloBE seeks to establish a synchronized taxation system that imposes an additional tax on profits generated in a jurisdiction whenever the effective tax rate (ETR), assessed on a jurisdictional basis, falls below the specified minimum rate. Pillar Two has been introduced into the field of international taxation to address global anti-base erosion and bolster global tax revenue. This is achieved through the development of a comprehensive and synchronized set of rules known as GloBE rules, which encompass the Income Inclusion Rule (IIR), the Undertaxed Payment Rule (UTPR) and the Switch-Over Rule (SOR).

Employing the global anti-base erosion paradigm as a reference for this section is crucial. First, global anti-base erosion is a shared objective of both Pillar Two and CFC rules.[60] While the specific purpose of a CFC regime varies depending on how the parent company's country treats negative income, the underlying concept of the system is to prevent tax deferral by addressing specific income transfers and countering base erosion resulting from profit shifting.[61] This would surely align with the objective of Pillar Two. Second, examining these systems could offer insights into the similarities and differences between CFC rules and Pillar Two, providing clarity on how Pillar Two will influence CFC rules in the future and, by extension, their implications for developing countries.

3.2. What is novel regarding Pillar Two? New rules in an old form?

An overview of the principal operating provisions of the GloBE rules apparently forms a system for completing the OECD/G20 BEPS Project, as some of the addressed issues arising from the digitalization of the economies remain unresolved. It is indeed a challenging task. Accordingly, the GloBE rules are drafted in the form of model rules to provide jurisdictions with a template for domestic implementations. It would not be wrong to argue that these somehow resemble some existing traditional specific anti-avoidance rules (SAARs).At first sight, the IIR, for example, appears to be akin to the current CFC rules, and this resemblance is explicitly acknowledged in the context of Pillar Two[62] and in the literature.[63] In general, both systems give the parent entity's jurisdiction the right to tax the income of a subsidiary incorporated in a low-tax jurisdiction. As a result, the entities involved (the parent entity and the foreign constituent and/or controlled entity), the elements in question (undistributed or distributed dividends) and the allocated taxing rights to the parent entity's jurisdiction bear some resemblance to a CFC system.[64]

The SOR is also planned to work as an anti-deferral mechanism to prevent the abuse of the exemption methods.[65] Currently, in addition to CFC rules, there are some other systems aiming to prevent deferrals. For instance, in the

53. OECD, *Addressing Base Erosion and Profit Shifting*, *supra* n. 31, at p. 18 et seq.
54. *See* OECD, *Bitesize BEPS – All FAQs, Action 3 – Strengthening Controlled Foreign Companies Rules* available at www.oecd.org/ctp/beps-frequentlyaskedquestions.htm (accessed 16 Nov. 2023).
55. There are also views in the doctrine claiming the contrary, in arguing that states have softened their CFC rules. *See* R.S. Avi-Yonah, *Back to the Future? The Potential Revival of Territoriality*, 62 Bull. Intl. Taxn. 10 (2008), Journal Articles & Opinion Pieces IBFD.
56. This will require a joint effort. However, it should also be questioned how this effort and the resulting rules will be met by non-OECD member countries. *See* Y. Brauner, *BEPS: An Interim Evaluation*, 6 World Tax J. 1, sec. 1. (2014), Journal Articles & Opinion Pieces IBFD. *See also* Kane, *supra* n. 8, at sec. 2.
57. OECD, *Addressing Base Erosion and Profit Shifting*, *supra* n. 31, at pp. 15-20.
58. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, Inclusive Framework on BEPS (OECD 2021), Primary Sources IBFD, also available at https://doi.org/10.1787/782bac33-en (accessed 16 Nov. 2023) [hereinafter *Global Anti-Base Erosion Model Rules (Pillar Two)*].
59. M.P. Devereux et al., *The OECD Global Anti-Base Erosion Proposal*, Oxford University Centre for Business Taxation p. 1 (2020), available at https://oxfordtax.sbs.ox.ac.uk/files/oecdglobeproposalreportpdf (accessed 16 Nov. 2023).
60. B.J. Arnold, *A Comparative Perspective on the US Controlled Foreign Corporation Rules*, 65 Tax L. Rev., p. 475 et. seq. (2011).
61. Id.
62. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 58, at p. 54.
63. The "Super-CFC", a term first used by J. Hey, *GloBE: Do We Need a Super-CFC (Forthcoming: Intertax, Vol. 49, 2021, Issue 1)*, Kluwer International Tax Blog (4 Nov. 2021), available at https://kluwertaxblog.com/2020/11/04/globe-do-we-need-a-super-cfc-forthcoming-intertax-vol-49-2021-issue-1/ (accessed 16 Nov. 2023). *See also* B.J. Arnold, *An Investigation into the Interaction of CFC Rules and the OECD Pillar Two Global Minimum Tax*, 76 Bull. Intl. Taxn. 6, sec. 3 (2022), Journal Articles & Opinion Pieces IBFD.
64. C. Theophilou, *Analysis of Pillar Two Primary Rule IIR – and Comparison With CFC Rules*, Bloomberg Tax (6 May 2022), available at https://news.bloombergtax.com/tax-insights-and-commentary/analysis-of-pillar-two-primary-rule-iir-and-comparison-with-cfc-rules (accessed 24 Nov. 2023).
65. P. Harris, *Corporate Tax Law: Structure, Policy and Practice* p. 378 (Cambridge U. Press 2013).

US system, there is a rule that empowers the US Internal Revenue Service (IRS) to transform the initial exemption method into an imputation method (a form of credit method) for taxing parent companies on non-portfolio dividends from non-resident entities.[66] A similar system can be found in the German *Gesetz über die Besteuerung bei Auslandsbeziehungen* (Foreign Transaction Tax Law, GBA).[67] Furthermore, the essence of the subject-to-tax rule (STTR) lies in the source country's entitlement to levy withholding tax.[68] In most EU Member States, domestic rules provide for a certain percentage of withholding tax on dividends paid by resident companies to non-residents.[69]

Lastly, the UTPR is also not that new. The UTPR and the STTR indeed favour the taxing rights of source countries, but with some peculiarities. For instance, first, the STTR is applied before the GloBE rules. Second, the taxable amount under the UTPR is calculated on the difference between the ETR and the minimum tax rate, while the amount in the STTR is based on the source country's tax rate. Third, the level of difficulty of the procedures is different. The UTPR has a relatively limited scope in practice, as the rule applies only if the MNE's ultimate parent entity (UPE) or intermediate parent entity does not adopt the IIR. In other words, the rule denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under an IIR.[70]

The application of the system is also too complex, being even beyond that of CFC rules. Accordingly, the tax is levied where any payment is made, and then the countries collectively charge top-up tax. Eventually, it would be safe to believe that although Pillar Two proposes a global minimum tax rate and a "new model" for operating the rules by providing a broader scope for the distribution of taxing rights, these four primary rules, including the GloBE rules, look like restatements and expansions of existing tax rules, in a way thereby challenging the international taxation principles.

66. US, Internal Revenue Code (IRC), sec. 902.
67. DE: *Gesetz über die Besteuerung bei Auslandsbeziehungen* (Foreign Transaction Tax Law, GBA), para. 20(2), which reads: "If income accrues in the foreign permanent establishment of a taxpayer with unlimited tax liability and is to be exempt from taxation on the basis of a treaty for the avoidance of double taxation, and the income would be taxable as interim income, notwithstanding…" and Section 8(2): "…if such permanent establishment were a foreign company, the double taxation shall be eliminated in this respect not by exemption but by crediting the foreign taxes levied on such income …" (Author's unofficial translation).
68. Harris, *supra* n. 65, at p. 234.
69. For instance, *see* DE: *Einkommensteuergesetz* (Income Tax Law, EStG), sec. 43(1)1.
70. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 58, at pp. 12-13 and OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* p. 3 (OECD 8 Oct. 2021), available at www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf (accessed 16 Nov. 2023).

4. A Comparative Look: CFC Rules and Pillar Two

4.1. Aims

The specific purposes of CFC rules can be divided into two main groups,[71] differing based on a state's method choice for eliminating double taxation.[72] In line with this, the prevailing approaches to CFC rules can be categorized as follows. The first involves taxing undistributed dividends of the parent company. The second entails directly taxing all or a portion of a CFC's income. As an illustration, in a tax regime in which a CFC is regarded as a transparent entity, all of the CFC income could be subject to taxation by way of the application of the piercing-the-veil approach. Alternatively, in recognizing the legal entity status of a CFC, negative income, including undistributed dividends, could be deemed to be taxable.[73] Nevertheless, this is still legal fiction-based taxation, and the CFC income is considered to be the parent company's income before it is distributed.

For instance, where the parent company's jurisdiction adopts an exemption method, the objective of CFC rules is to prevent the diversion of the income. Due to its simplicity and convenience, this method is frequently employed.[74] However, companies may use different profit-shifting systems. Assuming that the foreign tax rate is lower than the domestic tax rate, and that the residence state adopts an exemption method, the parent company could be incentivized to set up a subsidiary in a low-tax jurisdiction so as to be able to transfer the income to the subsidiary, and subsequently receive the income back as exempt dividend income.[75] In this regard, it should be noted that the underlying principle of CFC rules is the deemed dividend rule. This rule treats a portion of the income generated by a CFC as part of the income of the resident, allowing the shareholder's resident state to levy taxes on this income, even if it is not distributed.[76] The

71. Arnold, *supra* n. 60, at p. 477.
72. For more comparative analysis, *see* H.J. Ault & B.J. Arnold, *Comparative Income Taxation: A Structural Analysis*, pp. 477-488 (3rd ed., Wolters Kluwer 2010); D. Sandler, *Tax Treaties and Controlled Foreign Company Legislation* pp. 23-36 (2nd ed., Kluwer L. Intl. 1998); H.-J. Aigner, U. Scheuerle & M. Stefaner, *General Report*, in *CFC Legislation, Tax Treaties and EC Law* pp. 13-53 (M. Lang et al. eds., Kluwer L. Intl. 2004); and B.J. Arnold & P. Dibout, *General Report*, in *Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends*, International Fiscal Association (IFA), *Cahiers de Droit Fiscal International* vol. 86b (IFA 2001).
73. Rust, *supra* n. 47, at p. 492.
74. Harris, *supra* n. 65, at p. 278.
75. *See*, for example, *Taxes of Foreign Countries and of Possessions of United States, §902-Repealed, Foreign Corporation Tax Deemed Paid by Domestic Corporation, Credit for Taxes of Foreign Corporation-Repealed*, CCH AnswerConnet, available at https://answerconnect.cch.com/document/arp280a63fd047b6f100084ba78e7d18cbc280c4COPY/federal/irc/explanation/902-repealed-foreign-corporation-tax-deemed-paid-by-domestic-corporation (accessed 25 Nov. 2023). The deemed-paid foreign tax credit was repealed for the tax years of foreign corporations beginning after 31 December 2017, and for tax years of US shareholders in which, or with which, such tax years of foreign corporations end, by US: Tax Cuts and Jobs Act (P.L. 115-97). The deemed-paid credit was repealed as a result of the implementation of the participation exemption system under sec. 245A of the IRC.
76. R.S. Avi-Yonah, *Deemed Dividend Problem,* 4 Taxn. Global Transactions 33, p. 38 (2004). *See also* R.S. Avi-Yonah, *Deemed Dividend Problem,* Proceedings, Annual Conference on Taxation and Minutes of the Annual Meeting of the National Tax Association vol. 97, pp. 251-257 (2004).

other option is to adopt a credit method, under which CFC rules are aimed at avoiding the delayed or deferred distribution of specific income,[77] as in the US approach.[78]

According to the OECD, the creation of the GloBE rules constitutes a key component in addressing the tax complexities associated with the digital economy. These rules are intended to guarantee that MNEs contribute a minimum tax amount on the income generated in every jurisdiction in which they are active. The purpose behind implementing and overseeing the GloBE rules is to establish a transparent and all-encompassing taxation framework, ensuring predictability for MNEs and to mitigate the potential for both double and excessive taxation.[79] Accordingly, Pillar Two seeks to guarantee the taxation of income at a suitable rate and incorporates intricate mechanisms to ensure the payment of this tax. Consequently, the primary aim of Pillar Two is to address the unresolved issues of the post-BEPS digital era relating to tax matters.

4.2. Similarities and differences

4.2.1. In general

Although in precisely what situations the IIR could come into play where the existing CFC system is ineffective, and the legal implications of these scenarios remain uncertain, the OECD consistently highlights the interplay between the two systems within Pillar Two.[80] Broadly, the OECD's stance is quite explicit, asserting that CFC rules and the GloBE rules, particularly the IIR, are not formulating analogous regimes and are expected to coexist in the future.[81] However, most of the differences are only briefly mentioned. It is also argued in the literature that the interaction between CFC rules and the GloBE rules, especially with regard to the UTPR top-up tax, is indirect and results only where CFC rules have a direct effect on the IIR top-up tax.[82]

4.2.2. Scope of the systems

Pillar Two typically establishes a comprehensive global system. The policy considerations of CFC rules do not extend beyond the IIR of Pillar Two.[83] Accordingly, the objectives of the two systems appear to be relatively similar. Nevertheless, the difference in the scope of application of Pillar Two and CFC rules is significant.

In the case of Pillar Two, the range of entities included and the scope of the coordinated income are significantly broader compared to CFC rules. Pillar Two employs a jurisdictional blending approach regarding the income and taxation of various entities within MNC groups distributed across different jurisdictions worldwide.[84] Pillar Two also does not revolve around securing the taxation of domestic income as is the case with CFC rules. Instead, Pillar Two establishes a top-up tax that imposes an extraterritorial tax on foreign corporate profits generated by foreign group member companies, irrespective of the mechanism variant employed for this purpose.[85]

With regard to Pillar Two, the scope of the entities involved and the scope of the coordinated income are much larger than that of CFC rules. CFC rules solely concentrate on the income and tax liability of CFCs without addressing the interplay between multiple jurisdictions. Pillar Two adopts a jurisdictional blending approach regarding the income and taxation of different entities of MNCs allocated among various jurisdictions globally. The concept behind this is known as "tax follows profits", meaning that the tax burden will be assigned to the jurisdiction where the income is generated and documented.[86]

The rationale of CFC rules, i.e. the deemed dividends rule, means that the subsidiary's undistributed dividends are treated as the parent company's income, as the parent company has a de jure or de facto control over the subsidiary's operations.[87] For that reason, it is questionable whether these systems are consistent with the ability-to-pay principle.[88] Even if the dividends are generated but remain undistributed, where the parent company possesses decisive and controlling authority over the decision of distribution of dividends, the deemed dividends should be regarded as income attributable to the parent company.[89] Theoretically, it could be accepted that the undistributed income establishes the ability to pay base for the parent company.

In the context of Pillar Two, the issue can be examined from alternative perspectives. Depending on the resemblance, particularly between the IIR and CFC rules, it is possible to posit that Pillar Two could represent another extensive domain that is akin to the CFC regulations area.[90] Under the IIR, the low-tax income of the foreign constituent entity is anticipated to be incorpo-

77. This aim can be justified, as the deferral itself has a monetary value. *See* L. Lokken, *The Time Value of Money Rules*, 42 Tax L. Rev. 1, p. 108 et. seq. (1986).
78. US: Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (adding secs. 951-964, Subpart F of the IRC).
79. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 58, at p. 8.
80. J. Hey, *Guest Editorial: The 2020 Pillar Two Blueprint: What Can the GloBE Income Inclusion Rule Do That CFC Legislation Can't Do?*, 49 Intertax 1, p. 11 (2021).
81. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project p. 22 (OECD 2020), available at www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm (accessed 5 Dec. 2023) [hereinafter the *Report on Pillar Two Blueprint*].
82. Arnold, *supra* n. 60, at p. 272.
83. Id.
84. OECD, *Report on Pillar Two Blueprint*, *supra* n. 81, at p. 80.
85. M. de Wilde, *Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification*, Kluwer Intl. Tax Blog (12 Jan. 2022), available at https://kluwertaxblog.com/2022/01/12/why-pillar-two-top-up-taxation-requires-tax-treaty-modification (accessed 25 Nov. 2023).
86. J. Englisch, *International Effective Minimum Taxation – analysis of GloBE (Pillar Two)*, SSRN Paper, p. 12 (19 Apr. 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3829104 (accessed 25 Nov. 2023).
87. Avi-Yonah, *Deemed Dividend Problem,* Proceedings, *supra* n. 76, at p. 251.
88. *See also* A.P. Dourado, *Editorial: Pillar Two and the Principles of Ability-to-Pay, Legality and Symmetry*, 51 Intertax 6/7, pp. 448-450 (2023).
89. L. Riza, *Should Tax Law Mind Minority and Monitor Majority: The Case of Undistributed Dividends and the Ability-to-Pay Principle*, 13 Houston Bus. & Tax L. J., p.124 (2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2640948 (accessed 5 Dec. 2023).
90. Hey, *supra* n. 63 and *supra* n. 80, at pp. 9-10.

rated into the parent entity and taxed at the level of the UPE. However, the point of contention revolves around the issue of whether this taxation resembles a deemed dividend rule. However, under the Pillar Two system, the emphasis is not on whether dividends are distributed but, rather, on whether they are taxed at a specified level.

The ability-to-pay principle serves as a measurement for gauging the financial capacity of taxpayers to contribute to public revenue, and it should also be examined for compatibility with the goals of Pillar Two.[91] It would be safe to argue, though, that the system developed by Pillar Two does not recognize any principles regarding the ability to pay, but it only aims to set a top-up tax through a set of tax adjustment instruments.

In terms of accounting rules, both systems follow a similar approach. Accounting rules of the parent country are used to calculate income. Within a CFC regime, the most precise method for determining the tax liability of a foreign entity – referred to as the actual-foreign-tax-paid approach – involves computing the income and tax burden of the foreign entity using the accounting regulations of the parent country. Pillar Two adheres to similar principles, specifying that the calculation is based on the rules of the parent country, and is not constrained to book-to-book adjustments or limited-to-book adjustments.[92] However, there are some differences in the purposes. In the context of Pillar Two, this serves merely as a preliminary step in the calculation process, as the accounting rules of the parent company are utilized to compute the consolidated income of all entities within an MNC. Consequently, various procedures are necessary, including the allocation of income and tax liabilities among different entities, as well as the determination of the ETR. Nevertheless, this stage is crucial for the entire CFC regime as it determines the tax gap and enforces the taxing rights of the jurisdiction of the parent entity.[93]

4.2.3. The taxation system

Pillar Two and CFC rules diverge in terms of the taxes they encompass, with substantial distinctions observed in the tax base, tax rate and the jurisdiction responsible for tax collection between CFC rules and the minimum tax in Pillar Two.[94] Pillar Two encompasses a wider array of taxes, including both corporate income tax and withholding tax, which can be levied on both positive and negative income. In other words, the GloBE rules are designed to apportion the overall income and tax responsibility of MNCs within the corporate framework, targeting all forms of income. In contrast, CFC rules specifically relate to corporate income taxation and predominantly focus on passive income.[95]

In the implementation of the GloBE rules, i.e. the threshold for eligible MNCs, and specifically encompassing large MNCs with consolidated group revenues surpassing USD 750 million, has been established.[96] CFC rules do not have any limitation on the revenue generated. The threshold utilized in CFC rules, and implemented in certain countries, acts as an exemption method by establishing a *de minimis* level. This ensures that CFCs with annual revenues, or revenues attributed to the parent company below a certain threshold, are not subject to the relevant CFC rules.[97]

Another notable distinction between Pillar Two and CFC rules lies in the tax rates. The income determined under Pillar Two is not directly integrated into the domestic income base. Instead, it is distributed among various jurisdictions. Following the computation of the ETR, the variance from the minimum tax rate is imposed as a top-up tax. In contrast, CFC rules are designed under domestic tax law and the income of CFCs is subject to domestic tax rates.[98]

Moreover, the way Pillar Two defines low-tax income is still based on the ETR. If the ETR is lower than the global minimum tax rate, the GloBE rules will be applied to adjust the gap. However, determining low-tax income in CFC rules is more complicated. Primarily these approaches are used to determine the ETR, i.e. the "actual-foreign-tax-paid approach" for recalculation, the "low-taxed income approach" for tax rate comparison and the "designed jurisdiction approach".

Based on an examination of the objectives, while certain similarities can be noted initially, there is a fundamental divergence between the core elements, principles, scope of application and the foundation of Pillar Two when compared to CFC rules. It could also be argued that Pillar Two uses the final effect of CFC rules in building its system.

5. Possible Pillar Two Effects on the CFC Rules of Developing Countries

5.1. Looking back

First, it can be stated that the outbound capital investment capacity of countries is decisive in determining whether to have CFC rules under domestic laws.[99] This is especially important when a country's capital flows to other countries.[100] Especially for countries with the same tax treatment for inbound and outbound investments, creating incentives to establish a credit system based on

91. 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. 2.2. (2020), Journal Articles & Opinion Pieces IBFD.
92. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 58, at p. 53.
93. Hey, *supra* n. 80, at pp. 9-10.
94. Arnold, *supra* n. 60, at p. 277.
95. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 58, at p. 15 et seq.
96. Id., at p. 8.
97. OECD, *Action 3 Final Report* (2015), *supra* n. 3, at para. 53.
98. Hey, *supra* n. 80, at pp. 9-10.
99. S. Dueñas, *CFC Rules Around the World*, Tax Fund., Fiscal Fact No. 659, p. 31 (June 2019), available at https://files.taxfoundation.org/20190617100144/CFC-Rules-Around-the-World-FF-659.pdf?_gl=1*1hkxb8q*_ga*NTkzNTkwNzg3LjE2ODkyMzczNjE.*_ga_FP7KWDV08V*MTY4OTIzNzM2MS4xLjAuMTY4OTIzNzM2MS42MC4wLjA (accessed 26 Nov. 2023).
100. This is why, in the literature, the question is asked by E. Furuseth *CFC Taxation: A way for rich countries to steal from the poor?*, available at www.bi.edu/research/business-review/articles/2020/09/cfc-taxation-a-way-for-rich-countries-to-steal-from-the-poor/ (accessed 26 Nov. 2023).

capital export neutrality (CEN) was more beneficial.[101] Such a system allowed resident states to continue imposing a tax on foreign-source income, possibly with a deduction of the tax already paid abroad. Essentially, this supported domestic companies competing overseas.[102] As is well known, however, when the resident countries adopted only the credit method, resident companies were incentivized to defer the allocation of income. CFC rules are regarded as a remedy to avoid the possible tax loss from this deferral.[103]

The picture is also interesting from the legislative development perspective. According to the OECD Legislative Survey Report (2019),[104] out of the 122 inclusive framework members surveyed, 49 have CFC rules in operation with different approaches to the type of income covered and the presence of substantial activity tests. Only 18 countries have introduced CFC rules after the announcement of BEPS Action 3. Put differently, the implementation of BEPS Action 3 has not led to a substantial rise in the number of countries adopting a CFC regime. Moreover, following the introduction of Pillar Two, CFC rules no longer appear to be a primary focus of the OECD. The Pillar Two Report suggests that references to CFC are primarily there to highlight distinctions between Pillar Two and CFC rules, showcasing the innovative design of the Pillar Two framework.[105]

Furthermore, the anticipated evolution of CFC rules by the OECD appeared not to align entirely with the fundamental principles of the international tax system. In practice, certain countries levy taxes on all of the income of CFCs without making distinctions based on whether the income belongs to or is controlled by the parent company.[106] The OECD has advocated for an extension of the taxing authority of resident countries. This argument asserts that such an approach would permit the continual expansion of taxing rights for the jurisdictions of the parent companies, including the right to tax income sourced from third countries through CFCs.[107]

5.2. Looking ahead

Estimating the effects of Pillar Two, especially the global minimum tax, is not easy.[108] The effects on revenue can be analysed through direct and indirect effects. Direct effects illustrate the outcomes if the rules were implemented without any changes in behaviour from MNEs and governments. Indirect effects encompass the responses from MNEs, such as reducing profit shifting and investments, and from governments, such as reducing tax exemptions and increasing corporate income tax rates. In the absence of responses from MNEs or governments, the direct effects primarily favour resident countries, which would gain initial taxing rights under the IIR.[109] Given that the UPEs of MNEs are often situated in high-income countries, these direct effects will predominantly benefit those countries. This is not a secret, as even the OECD estimates under several scenarios that direct effects could increase corporate income tax revenues by between 2.2% and 4% in high-income countries, between 1.0% and 1.8% in middle-income countries and from 1.2% to 2% in low-income countries.[110]

It is now time to ask whether the IIR in Pillar Two will replace the CFC tax system, which will then disappear in the future. In other words, the question is whether each country will set some criteria to determine the level of foreign tax paid or adopt the global minimum tax rate of 15%, and whether a parent country would be entitled to tax the CFC. The answer to these questions may depend on different aspects, being the parent country's domestic rate and the criteria determining the low-tax jurisdiction, respectively.[111] If the parent country has a high tax rate compared to the global minimum tax rate, CFC rules are likely to apply if the foreign country's ETR is low. In this case, CFC rules would still be attractive for developed countries,[112] as replacing CFC rules with the IIR would mean less tax revenue. However, if a country's tax rate is lower than 15% and the standard of applying CFC rules is even, the IIR may play approximately the same role as CFC rules, or be even more attractive, as it has a wider scope.[113]

Ultimately, it depends on observing how MNEs adjust their business decisions. In response to the effect of

101. P.J. Wattel, *Capital Export Neutrality and Free Movement of Persons*, 23 Leg. Issues Econ. Integration 1, p. 116 (1996).
102. *See* H. Grubert & J. Mutti, *Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?* 2 Intl. Tax & Pub. Fin. 3, p. 449 (1995).
103. Nevertheless, for countries that import capital, the presence of CFC rules could give rise to diverse consequences. This includes potential escalation in the enforcement costs for tax authorities, influencing the equitable allocation of resources and potentially affecting foreign investment development by augmenting the compliance burdens on companies. *See* Dueñas, *supra* n. 99, at p. 33.
104. OECD, Corporate Tax Statistics Database, available at https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm and https://qdd.oecd.org/subject.aspx?Subject=CFC (accessed 26 Nov. 2023).
105. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), First Edition: Inclusive Framework on BEPS*, (OECD Publishing), p. 194 et seq. (2022), available at https://doi.org/10.1787/1e0e9cd8-en (accessed 26 Nov. 2023).
106. For instance, Brazil is the most extreme in terms of the level of share ownership and other factors. The Brazilian CFC rules apply to all of the income of any foreign corporation over which a Brazilian resident corporation has significant influence. *See* Arnold, *supra* n. 60, at p. 480.
107. OECD, *Action 3 Final Report* (2015), *supra* n. 3, at para. 44.
108. *See*, for example, R. Codorniz Leite Pereira, *Pillar Two and Developing Countries: The Perils of Jurisdictional Blending*, 15 World Tax J. 4, sec. 3.5. (2023), Journal Articles & Opinion Pieces IBFD, where it is stated that: "… there is no evidence of the potential gains that other Pillar Two-related measures can bring to developing countries. In fact, a more careful analysis of each of them reveals that their scope is too narrow and insufficient to address developing countries' concerns."
109. I. Steel & V. Nair, *International corporate tax reforms. what could the OECD deal mean for lower-income countries? ODI Emerging Analysis,* London: ODI, Working Paper 618, p. 13 (29 Oct. 2021), available at https://ifs.org.uk/publications/international-corporate-tax-reforms-what-could-oecd-deal-mean-lower-income-countries (accessed 26 Nov. 2023).
110. OECD, *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS,* OECD/G20 Base Erosion and Profit Shifting Project pp. 111-119 (OECD 2020), available at https://doi.org/10.1787/0e3cc2d4-en (accessed 26 Nov. 2023) [hereinafter the *Economic Impact Assessment: Inclusive Framework on BEPS*].
111. *See* S. Tandon, *Assessing the Impact of Pillar Two on Developing Countries*, 50 Intertax 12, p. 934 (2022).
112. Steel & Nair, *supra* n. 109, at p. 3.
113. Hey, *supra* n. 80, at p. 6.

increased investment costs, MNEs will probably reconsider the location of their investments. According to the OECD, this would be the end of the tax haven era, as countries with low tax rates would lose their attractiveness.[114] Then, MNEs could consider other aspects when choosing an investment location. In any case, however, the author believes the tax rates will be the first determinant.

There could be other non-tax factors that could affect decisions on investments. The purpose of Pillar Two is to reduce the gap in substantive tax rates between countries by establishing a global minimum tax rate and to mitigate tax competition between countries using very low tax rates. MNEs can consider the infrastructure, labour costs, education levels and other factors to choose the most economically productive place to invest. Interestingly, it is argued that tax incentives are not the most important factor when MNCs choose their investment locations compared to other non-tax factors.[115] In the end, the top-up tax would essentially offset some of the benefits of tax incentives. This would definitely affect the attractiveness of the developing countries that especially trust tax incentives to attract and support investments.[116]

An example could be helpful to illustrate the interaction between CFC rules and the IIR from a tax incentive point of view. Assume that a country has a participation exemption under its domestic law, i.e. for the companies that participated in foreign companies. One of the conditions to benefit from the exemption is that the participating company must bear a total tax burden, including taxes paid on profits that form the basis for the distribution of dividends from foreign income, of at least 15%. On the other hand, the CFC low-tax threshold is set at 10%. In this case, this country opts to apply the IIR as a top-up tax at the rate of 15%. If the CFC is first taxed in line with CFC regulations, as it has been carrying a tax burden below 10%, i.e. 9%, the top-up tax will roughly compensate the remaining 6%. At this stage, the CFC has not distributed dividends; therefore, it cannot benefit from the participation exemption. The first possibility is that the tax burden under the domestic law of the parent company could be higher than 15%, making the application of the IIR unnecessary. Ultimately, the CFC will be taxed according to the domestic tax rate, most probably around 20% or, in some cases, at a reduced rate, i.e. at the provisional tax rate, most probably at 15% (logically, at a minimum of 10%). If the country's corporate income tax rate is less than 15%, the application of top-up tax will compensate for the tax gap for a while.

In another scenario, assume that the CFC threshold is in excess of 15%, i.e. 25%. This country should align its CFC threshold with the minimum top-up tax rate. Such a situation would mean that if the CFC's tax rate of income is 15% or more, no additional tax would be imposed, even where the tax rate is less than 25%.[117]

However, there are other scenarios that could significantly impact the implementation of these two systems. Initially, it was assumed that the CFC had not distributed dividends. The parent jurisdiction applied CFC rules, taxing the CFC income accordingly. What will happen in a post-dividend distribution situation? In many CFC systems, the untaxed part of the CFC income becomes subject to corporate tax in subsequent distribution. Additionally, the income and corporate income taxes, or equivalent taxes, paid in the CFC country can be offset against the corporate income tax calculated on the CFC's taxable income in the parent jurisdiction. Consequently, after dividend distribution, whether the CFC was taxed under the CFC threshold becomes less significant.[118] The CFC will adhere to the domestic tax rate of the jurisdiction in which it was established. If the IIR applies and compensates for the 6% tax gap, it could profoundly affect outbound investment flows, and contradict the tax policy of a developing country utilizing the participation exemption as a tax incentive. If that country aligns the CFC threshold with the minimum top-up tax rate, CFC rules will capture every domestic company's participation in a foreign company, basically making the participation exemption meaningless. For that reason, that country would prefer to retain its regulations as they are regulated and it would not be necessary to implement any top-up tax if the income is taxed in line with the domestic tax rates. This is also valid in the second scenario, as aligning the high threshold with the top-up tax would similarly affect the participation exemption system of those countries if they also have similar tax rates.

6. Conclusions

Returning to the research questions of this article (How would developing countries be affected by adapting CFC

114. OECD, *Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) (OECD 8 Oct. 2021), available at www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf (accessed 26 Nov. 2023); OECD, *Global Anti-Base Erosion Rules (Pillar Two)* (OECD), available at www.oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf (accessed 26 Nov. 2023).
115. OECD, *Economic Impact Assessment: Inclusive Framework on BEPS*, *supra* n. 110, at p. 172.
116. In line with this view, *see* Codorniz Leite Pereira, *supra* n. 108, at p. 12.
117. For instance, DE: *Bundesministerium der Finanzen* (Ministry of Finance) recently released a draft bill to partially repeal its CFC regime on introducing the GloBE rules into German domestic tax laws. The CFC minimum tax rate threshold will be reduced from 25% to 15%. *See* DE: Ministry of Finance, *Referentenentwurf eines Gesetzes für die Umsetzung der Richtlinie zur Gewährleistung einer globalen Mindestbesteuerung für multinationale Unternehmensgruppen und große inländische Gruppen in der Union und die Umsetzung weiterer Begleitmaßnahmen (Mindestbesteuerungsrichtlinie-Umsetzungsgesetz – MinBestRL-UmsG)*, available at www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_IV/20_Legislaturperiode/2023-08-18-MinBestRL-UmsG/1-Referentenentwurf.pdf?__blob=publicationFile&v=2 (accessed 23 Nov. 2023). *See also* T. Masuda, *Should Countries Declutter Their CFC Legislation Once They Adopt the Global Minimum Tax?*, Kluwer Intl. Tax Blog (28 July 2023), available at https://kluwertaxblog.com/2023/07/28/should-countries-declutter-their-cfc-legislation-once-they-adopt-the-global-minimum-tax/ (accessed 23 Nov. 2023).
118. It is also suggested in the literature that even limiting the tax burden on the inclusion amount to a low minimum tax rate is necessary so as to not risk the competitiveness of the subsidiaries of MNEs. *See* J. Englisch & J. (Johannes) Becker, *International Effective Minimum Taxation – The GLOBE Proposal*, 11 World Tax J. 4, sec. 2.2.6. (2019), Journal Articles & Opinion Pieces IBFD.

regulations and Pillar Two? Are the interests of developing countries protected at all?), the following answers could be provided as a conclusion.

In addition to some potential disadvantages, it must be admitted that CFC rules offer some advantages: they can help developing countries increase their tax revenue by preventing their own MNEs from shifting profits to low-tax jurisdictions. However, the implementation of CFC rules should be balanced and fair, considering each country's specific economic and political context. The general picture of the BEPS initiative basically disregards the nuance of tax systems that are influenced by often competing economic interests. Remarkably, the United States advertised its CFC rules, and the OECD tried to make them widely accepted with the OECD/G20 BEPS Project. However, most probably, due to the lack of success, Pillar Two was initiated as an additional option.

The author believes that if not well designed, CFC regimes can discourage foreign investment and affect not only inbound but also outbound flows if the minimum tax thresholds are not set carefully. The application of Pillar Two rules, along with CFC rules, could reduce the ability of developing countries to use tax policies as a tool for attracting investment, as MNEs would be subject to a minimum tax rate, regardless of the host country's tax regime. Higher tax burdens resulting from the minimum tax requirements could reduce the attractiveness of these countries as investment destinations, depending also on the details of the global minimum tax and the specific circumstances of each country. In the end, Pillar Two limits the ability of developing countries to offer preferential tax rates. Moreover, it forces countries to adopt a minimum tax rate for all kinds of tax regimes and incentives.

The GloBE rules and CFC regimes may not overlap and may coexist as the OECD states. However, this would not make matters better for developing countries as it would create an even greater scope of taxation for the residence countries, especially when a CFC does not account for the domestic minimum tax. Although the OECD, since the Pillar Two Blueprint,[119] asserts that there will be no practical issues, the author respectfully disagrees with this perspective and, conversely, believes that there is indeed a concern here. Finally, the author argues that the interests of developing countries have not been sufficiently taken into account.

119. OECD, *Report on Pillar Two Blueprint*, *supra* n. 81, at p. 173 et. seq.