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Coordination of Undertaxed Payment Rules With Bilateral Income Tax Treaties

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INTRODUCTION

In January 2019, the Organisation for Economic Co-operation and Development (OECD) published a policy note describing two major "pillars" of work in its ongoing efforts to limit what it has long described as base erosion and profit shifting (BEPS).[1] Pillar One is meant to revise taxable nexus rules to allocate a greater share of income from certain businesses to the jurisdictions in which the relevant customers are located. Pillar Two takes a broader approach, generally seeking to impose an internationally coordinated 15% minimum tax on multinational enterprises' (MNEs') worldwide income. In October 2020, the OECD released a blueprint describing the proposed Pillar Two regime.[2] In December 2021, the OECD published model rules (the Global Anti-Base Erosion, or GloBE rules) laying out how countries could implement Pillar Two.[3] In March 2022, the OECD published commentary and examples illustrating the operation of the GloBE rules.[4]

Since then, in addition to technical concerns regarding how this unprecedentedly ambitious international tax regime will operate, the project has encountered significant political and practical obstacles, including failed attempts in both the United States and the European Union to enact the necessary implementing legislation for Pillar Two.[5] While these obstacles may eventually be cleared, they do force policymakers, taxpayers, and tax advisors to contemplate a scenario in which the rollout of Pillar Two is both delayed and incomplete in terms of the participation of key economies. These obstacles also, however, provide some time to make further adjustments to the design and implementation of the proposed rules.

This commentary addresses one important aspect of Pillar Two implementation, specifically the coordination of Pillar Two's undertaxed payment rule (UTPR) with the existing network of bilateral income tax treaties based on the OECD and U.S. models.[6] The commentary argues that policymakers would be wise to provide for explicit coordination of the UTPR with bilateral income tax treaties, in order to protect the intended operation of both the UTPR and tax treaties, and to avoid the protracted controversies that undoubtedly will arise without better coordination of the UTPR with the existing treaty framework, especially in a world with only mixed uptake of Pillar Two by key jurisdictions.

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[1] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy — Policy Note* (Jan. 2019).

[2] OECD, *Tax Challenges Arising from Digitalisation—Report on Pillar Two Blueprint: Inclusive Framework on BEPS* (Oct. 2020) (OECD Blueprint).

[3] OECD, *Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules: Inclusive Framework on BEPS (Pillar Two)* (Dec. 2021) (Pillar Two Model Rules).

[4] OECD, *Tax Challenges Arising from the Digitalisation of the Economy—Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)* (Mar. 2022) (Pillar Two Model Commentary).

[5] Pillar One seems to be on an even slower implementation track.

[6] OECD, *Model Tax Convention on Income and on Capital* (2017) (OECD Model Treaty); U.S. Treasury Department, *United States Model Income Tax Convention* (2016) (U.S. Model Treaty).

PURPOSE AND DESIGN OF UTPRS

At a very high level, Pillar Two aims to tax the worldwide income of the largest MNEs at a rate of at least 15%, to be imposed by the MNE parent company jurisdiction, various source-country jurisdictions, or some combination thereof. The main mechanism of Pillar Two is the income inclusion rule (IIR), under which the MNE parent company jurisdiction would impose a top-up tax (TUT) with respect to each low-taxed constituent entity in the group (i.e., an entity in a country in which the group's effective tax rate (ETR) is determined to be less than 15%).[7] The IIR tax with respect to a constituent entity is reduced to the extent of any qualified domestic minimum top-up tax (QDMTT) imposed by the entity's residence jurisdiction. The QDMTT mechanism effectively allows a low-tax jurisdiction to increase its tax rate to 15% and thereby collect the additional TUT revenue that otherwise would be collected by the MNE parent company jurisdiction under the IIR, while allowing the jurisdiction to provide a substance-based income exclusion based on local property and payroll.

The UTPR would operate as a backstop to the IIR in situations in which no MNE group parent or intermediate entity applies a qualifying IIR. In these situations, the UTPR would apply to impose a UTPR TUT amount equal to the amount of IIR tax that would have applied had the MNE parent company jurisdiction imposed a qualifying IIR. If multiple jurisdictions apply a UTPR to a group, the resulting tax liability would be divided among the jurisdictions on a formulary basis (number of employees and value of tangible assets in the jurisdiction, weighted 50-50).[8]

ATTEMPTING TO SQUARE UTPRS WITH BILATERAL INCOME TAX TREATIES

Bilateral income tax treaties based on the OECD Model Treaty and the U.S. Model Treaty, in relevant part, establish a framework for allocating taxing rights with respect to MNE income among residence and source jurisdictions based on separate-entity accounting, employee/agent business presence, and arm's-length pricing of related-party transactions. Under this framework, residence countries generally are entitled to tax the business profits of their resident entities, and source countries generally cannot tax the business profits of entities resident in the other treaty country, except to the extent attributable to a permanent establishment in the source country.[9] This mitigates juridical double taxation (taxation of the same income in the hands of the same entity by two different jurisdictions). Tax treaties generally include a "saving clause" providing that the treaty does not impose limits on a residence country's ability to tax its own residents, subject to several exceptions.[10] Transactions between related entities are priced under the arm's-length standard, to be applied on a coordinated basis and with correlative adjustments by the taxing jurisdictions concerned.[11] This mitigates economic double taxation of the same income in the hands of two different entities by their respective residence countries.

Tax treaties also include non-discrimination provisions, under which the contracting states generally agree in relevant part not to impose deduction limits or other taxation requirements on resident subsidiaries of parent companies resident in the other treaty country that are more burdensome than the limits or requirements that would apply to other similarly situated resident companies.[12] The saving clause noted above does not apply to a treaty's non-discrimination provisions (nor to certain aspects of the arm's-length pricing provisions).

Pillar Two's UTPR sits uneasily at best alongside existing bilateral income tax treaties. The UTPR effectively allows a source country to tax the business profits of an entity resident in a different country, on a formulary basis, due to a conclusion that the residence country (and other source countries) have imposed an insufficient level of taxation on those profits. This result may be subject to challenge under the business profits, associated enterprises, and non-discrimination articles of standard tax treaties. The OECD to date has taken the position that the UTPR does not violate any of these common treaty provisions, primarily based on an argument that a jurisdiction imposing a UTPR is simply taxing its own resident entity as is permitted under the saving clause, and is not discriminating because the UTPR applies

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[7] The IIR is conceptually similar to, and inspired by, the U.S. global intangible low-taxed income (GILTI) regime, although key countries have taken the view that present-law GILTI does not constitute a qualifying IIR unless it is modified to be imposed at a higher ETR and on a country-by-country basis.

[8] This formulary approach to the UTPR was a new development in the December 2021 Pillar Two Model Rules. Earlier OECD releases had envisioned the UTPR as a deduction disallowance rule applied to related-party payments, as opposed to an additional tax imposed by a jurisdiction simply on the basis of that jurisdiction's proportion of the group's employees and tangible asset value. The tax may be imposed via deduction disallowance or some other mechanism, in all cases targeting an amount of tax consistent with the formulary result.

[9] OECD Model Treaty, arts. 5 (Permanent Establishment) and 7 (Business Profits); U.S. Model Treaty, arts. 5 (Permanent Establishment) and 7 (Business Profits).

[10] OECD Model Treaty, art. 1(3) (Persons Covered); U.S. Model Treaty, art. 1(4) and (5) (General Scope).

[11] OECD Model Treaty, arts. 9 (Associated Enterprises) and 25 (Mutual Agreement Procedure); U.S. Model Treaty, arts. 9 (Associated Enterprises) and 25 (Mutual Agreement Procedure).

[12] OECD Model Treaty, art. 24 (Non-Discrimination); U.S. Model Treaty, art. 24 (Non-Discrimination).

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on the basis of a group ETR profile in a jurisdiction as opposed to the residence of the recipient of a related-party payment.[13]

These arguments by the OECD can and presumably will be challenged in various national courts around the world by affected taxpayers. With respect to the business profits provisions of tax treaties, a country imposing a UTPR is effectively taxing the business profits of other group entities, even if such profits are not attributable to any permanent establishments of such entities in the UTPR-imposing country. Moreover, the UTPR can be imposed on the income of entities that sit above or alongside the UTPR entity in the ownership chain, and thus, unlike in the case of controlled foreign corporation (CFC) regimes or Pillar Two's IIR, the UTPR cannot be defended as a tax imposed on a resident shareholder's participation in the ownership of a subsidiary. Viewed from the perspective of the UTPR entity, the UTPR can tax the entity on more than its arm's-length profits, potentially implicating the associated enterprises provisions of tax treaties and creating pricing problems to be worked out between the relevant competent authorities under mutual agreement proceedings.

The OECD has stated that the UTPR does not violate the business profits or the associated enterprises articles of tax treaties, because the UTPR-imposing country is doing nothing more than taxing its own resident entities in the manner it wishes, as it is permitted to do under the saving clause.[14] Affected taxpayers undoubtedly will put this proposition to the test in litigation around the world. While it is true on a technical level that a UTPR tax liability would be imposed on an entity resident in the UTPR-imposing country, the UTPR in substance would violate both the business profits and the associated enterprises articles of tax treaties, leaving various courts to determine whether a contracting state to a tax treaty can be bound to the substance of its contract or instead only to its form.[15]

Similarly, with respect to non-discrimination, affected taxpayers will put to the test the OECD's argument that the UTPR does not depend on the residence of higher-tier entities in the ownership structure, but instead depends only on group ETRs, as an attribute ungoverned by non-discrimination provisions, and could theoretically apply to an entirely domestic payment.[16] Here the saving clause is not available to defend the UTPR, leaving various national courts to determine for themselves what it means for a tax provision to operate based on the residence of a higher-tier entity, and what it means for foreign and domestic entities to be similarly situated within the meaning of non-discrimination principles.

CONCLUSION

A key goal of the OECD's BEPS project in general, and of Pillar Two and the GloBE in particular, has been for countries to come together and agree on a framework, in order to avoid the chaos and controversy that a multitude of unilateral measures would inevitably entail. That goal was always a lofty one, and recent events demonstrate how difficult this level of coordination will be to achieve. At this point, it seems likely that some countries will proceed with Pillar Two implementation, including UTPRs, while others will not, or will do so with varying degrees of delay. Taxpayers affected by UTPRs can be expected to look to bilateral tax treaties for relief, and national courts can be expected to reach a range of different conclusions on these issues. This is a recipe for the kind of chaos and controversy that the OECD work was meant to prevent.

Far better would be for policymakers to take the time to integrate Pillar Two properly with the existing bilateral income tax treaty framework, rather than simply contending that they have engineered a way to render that framework a vestigial organ and hoping for the best. Even the OECD has acknowledged that explicit treaty accommodation of Pillar Two would be, if not mandatory, at a minimum desirable as a way to achieve optimal coordination and certainty.[17] The prospect of an extended period of Pillar Two implementation, with significant diversity among key economies in terms of implementation timing and mechanics, makes it even more desirable to tackle the tax treaty aspects of Pillar Two head on.

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[13] *See* OECD Blueprint, §10.4. Note that the OECD Blueprint was issued in 2020, prior to the redesign of the UTPR in the December 2021 Pillar Two Model Rules. As modified, the UTPR now would be allocated on a formulary basis and is not necessarily keyed in any way to limiting deductions on a related-party payment.

[14] *See* OECD Blueprint, §10.4.

[15] In addition, the requirement of the associated enterprises article to provide correlative adjustments is an exception to the saving clause, thus placing these transfer pricing issues within the ambit of treaty-based mutual agreement proceedings, even if the country imposing the primary adjustment is not barred by treaty from doing so.

[16] *See* OECD Blueprint, §10.4, at ¶691.

[17] *See* OECD Blueprint, §10.5.3 ¶¶705–08 ("Although it is not a prerequisite, a multilateral convention would be the only means to enshrine rule coordination in a legally binding form. Inclusive Framework on BEPS members will therefore develop provisions that could be included in a new multilateral convention and that would be designed to ensure consistency, certainty and coordination in the application and operation of the IIR and UTPR. . . . A multilateral convention could also confirm the compatibility of the GloBE rules with existing double tax treaties providing further certainty for the operation of the GloBE rules. Furthermore, it could contain exchange of information and dispute resolution mechanisms. . . .").

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